

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

Contents

| | |
|--|-----------|
| Executive Summary | 02 |
| Economic Trends and Outlook | 04 |
| Recent Developments | |
| Outlook for 2011 | |
| Policy Issue | 10 |
| Recent Publications | 11 |



Korea Economic Research Institute

Korea's Economic Growth for 2011 Adjusted to 3.9%

A downward adjustment of the 2011 Korean economic growth forecast to 3.9%, 0.2 percentage point lower than the 4.1% projected in January 2011, was made because, despite the positive influence (about +0.6 percentage point) of the U.S. economic recovery, a negative factor (about -0.8 percentage point) associated with sharp international oil and raw material price hikes is expected to have more impact. By sector, private consumption and construction investment projections for 2011 were adjusted sharply lower. Affected by worsened purchasing power following interest rate increases and inflationary pressure, private consumption growth is likely to come in at 3.2%, 0.6 percentage point lower than the previously projected 3.8%. Construction investment, for which mild growth (0.6%) was forecasted earlier, is expected to reverse course to a downward trend for the year due to the housing business slowdown and worsening of construction business, etc. in the wake of a 12% decline in the first quarter of 2011.

CPI Growth Adjusted to 4.2%

A 1.0 percentage point upward adjustment was made in the consumer price index (CPI) growth projection compared with the earlier forecast due to worsened price environments since early this year, making it difficult to improve significantly as the world faces a high oil price situation, influenced by the Middle East crises and Japan's major earthquake.

Current Account Surplus to Fall to About US\$12 Bil.

Due to the faster-than-expected appreciation of the Korean won against the U.S. dollar and an increase in the import account caused by higher international oil and raw material prices, the current account surplus is projected at US\$12.8 billion, about US\$2 billion less than the US\$14.5 billion forecasted earlier. The won-U.S. dollar exchange rate is expected to decline gradually to average less than 1,080 won for the year., affected by a continuation of the higher U.S. dollar supply market.

Need to Prevent Slowdown in Private Consumption Recovery

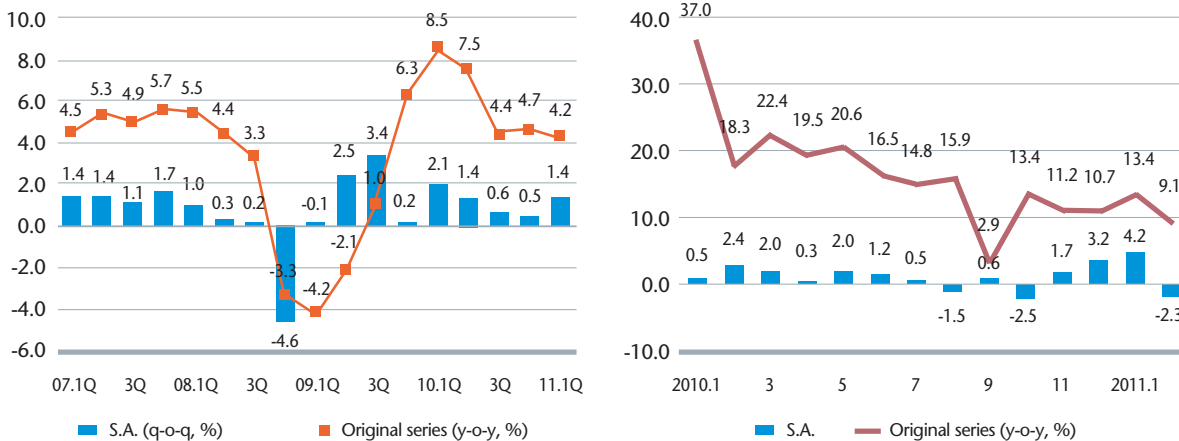
The recovery of private consumption is feared to slow due to continuous increases in household debt and sharp increases in 'Jeonse price' (long-term rental deposit to lease an apartment or house) as well as price instability and interest rate rises. In the medium and long term, the price ceiling system for new apartments, which is causing price increases through supply shrinkage, should be abolished. Furthermore, introduction of a monthly rent and 'Jeonse' ceiling system is not desirable because it may aggravate the instability of the 'Jeonse' market by stimulating 'Jeonse' demand among those waiting to purchase apartments or houses. In preparation for interest rate increases, there is a need to revamp debt adjustment and bankruptcy policies for low-income and elderly classes who have more financial debt than income.

Recent Developments

GDP Growth Slowed Since 1st Qtr. of '10

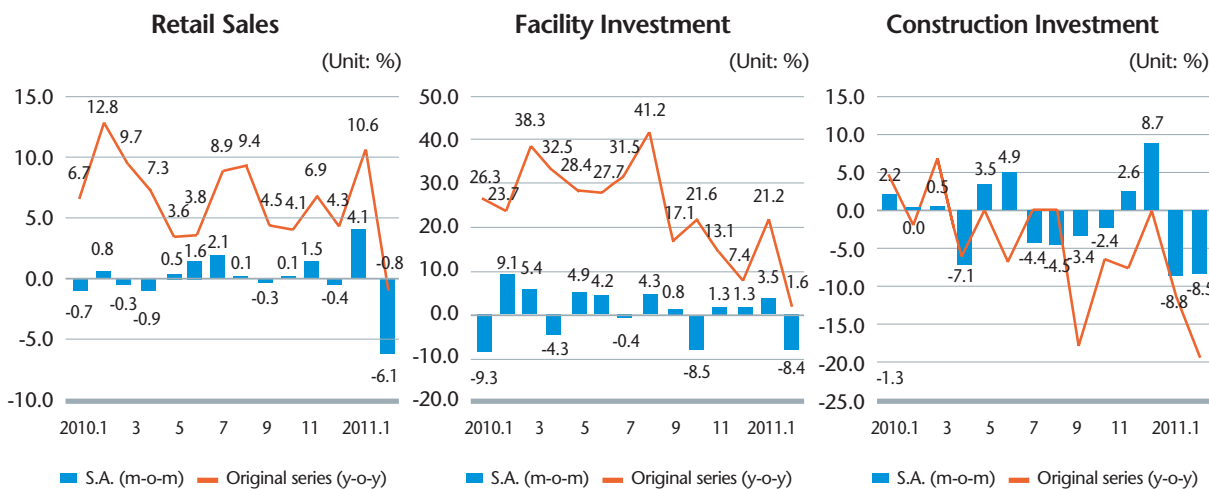
GDP growth in the first quarter of this year slowed to 4.2% year-on-year, down from 4.7% in the preceding quarter. Industrial production growth also declined to 11.4% from 11.7%.

GDP Growth and Industrial Production



Domestic Demand Sectors on the Decline

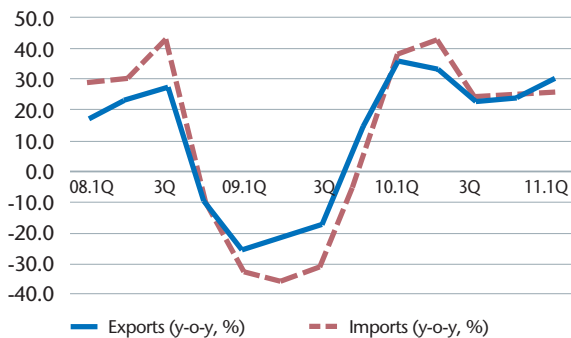
With retail sales slowing, facility investment had improved slightly for the three months following October 2010, but fell sharply in February this year. Construction investment also declined significantly in January-February this year after a temporary growth in November-December 2010.



Exports & Imports Expand, Current Account Surplus Lower

Exports grew 29.9% year-on-year in the first quarter of this year from 23.8% in the fourth quarter of 2010, and imports also posted high growth of 25.6%. As the service balance deficit expanded on top of a shrinking commodity balance, the current account surplus contracted.

Exports, Imports and Current Account Balance

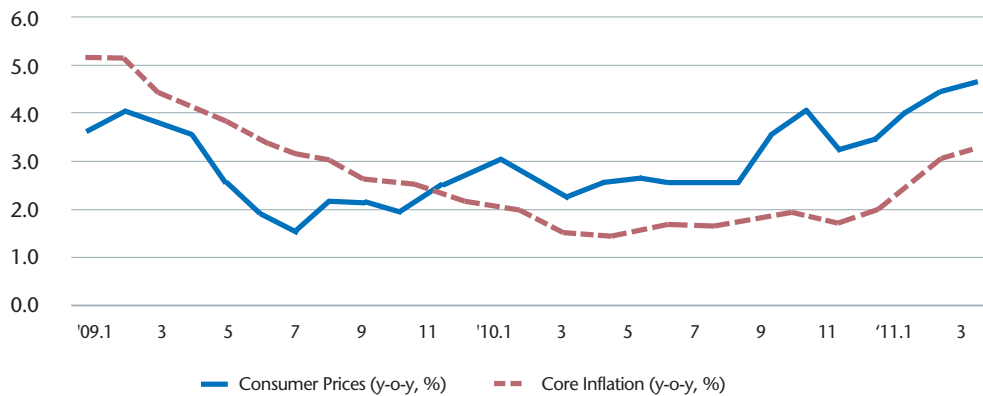


| | 2010 | | | | 2011 |
|-----------------|-------|-------|-------|-------|-------|
| | 1/4 | 2/4 | 3/4 | 4/4 | 1-2 |
| Current Account | 2.6 | 88.6 | 99.3 | 91.6 | 13.3 |
| Commodity | 47.9 | 122.4 | 125.4 | 123.4 | 31.4 |
| Service | -42.0 | -18.7 | -29.5 | -22.0 | -22.1 |
| Income | 5.5 | -10.1 | 13.0 | -0.7 | 12.5 |
| Transfer | -8.7 | -5.0 | -9.5 | -9.1 | -8.4 |

Consumer Prices on the Rise

With rises in international raw material prices, including crude oil, in conjunction with a double-digit increase in farm, livestock and fishery product prices, consumer inflation continued the upward trend for the third consecutive month since January this year, reaching the 4% level.

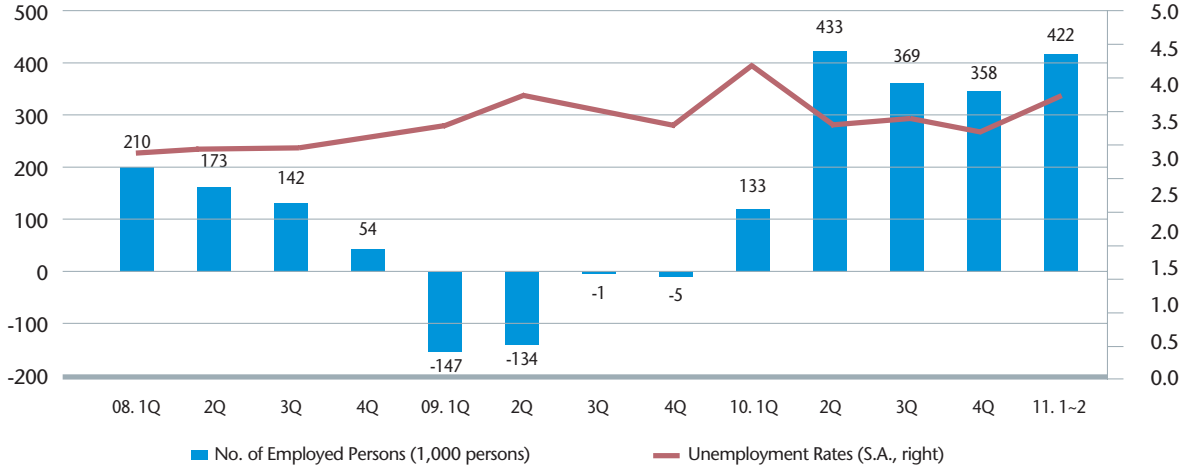
Prices



Employment Recovery Continued

The number of employed persons increased by about 420,000 in the first quarter of this year compared with the same period of 2010. The unemployment rate also improved to 4.2% in the first quarter from 4.7% in the fourth quarter of 2010.

Employment



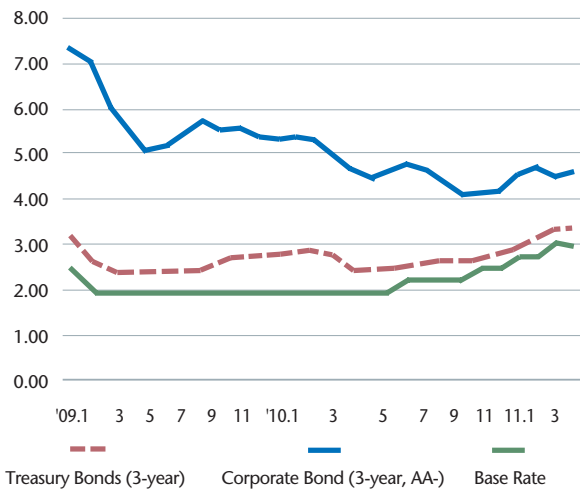
Market Interest Rates Down Slightly

Interest rate push pressure weakened owing to expanded investment by foreigners in bonds, higher liquidity, increased uncertainty over the economic recovery, etc., in spite of base interest rate and consumer price increases.

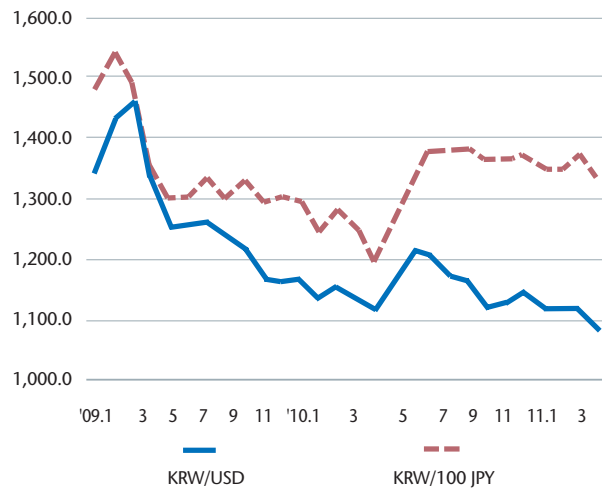
Won-U.S. Dollar Fx. Rate Declining

The won-U.S. dollar exchange rate continued to fall as U.S. dollar supply markets expanded, caused by inward overseas capital investment, trade surplus, etc.

Interest Rates



Exchange Rates



Outlook for 2011

1. Internal and External Environments

Uncertainty Increasing Over World Economic Growth

In the United States, the economic recovery momentum has continued since early this year. However, uncertainty over whether the recovery will continue is increasing, including whether the U.S. QE2 (2nd round of Quantitative Easing) will end, the possibility of a retrenchment policy following S&P's downgrade of the U.S. credit rating outlook, etc. Japanese economic growth is projected to fall due to delays in recovery from the earthquakes and the nuclear power plant situation. The EU region's strengthened financial retrenchment as it emerges from the financial crisis and China's reinforced retrenchment for fear of economic vitality decline in response to price hikes are expected to be key variables for the world economy.

International Oil Prices in 2011 Projected at US\$105/bbl.

Influenced by demand growth in emerging economies, increases in global liquidity, a weakening dollar, political instability in MENA (Middle East and North Africa), Japan's earthquakes, etc., there is a high possibility that international oil prices may continue to rise in future.

Global Dollar Weakening Tone to Ease

Since comparatively better economic growth is projected for the U.S. economy than for Japan or the EU, the weakening trend of the U.S. dollar against the Euro and yen currencies is expected to ease.

Economic Stimulus Potential to Weaken in Internal Environment

Fiscal consolidation may continue with a 2011 budget bill that foreshadows more revenues than expenditures. As price push pressure gradually rises, it will be unavoidable to increase base interest rates. However, careful interest rate increases are expected in the second half of this year in consideration of uncertainty over the economic recovery trend, such as democratization in the Middle East, major earthquakes in Japan, re-emergence of financial crisis in Europe and other factors.

Key Assumptions for Projections

| Exogenous Variables | Unit | 2010 | 2011 |
|-------------------------|-----------|------|-------|
| China's Growth | % | 10.3 | 9.6 |
| Japan's Growth | % | 3.9 | 1.4 |
| U.S. Growth | % | 2.8 | 2.8 |
| Dubai Oil Price | US\$/bbl. | 78.1 | 105.0 |
| Base Rate (end of year) | % | 2.50 | 3.50 |

2. Outlook for Korean Economy

Growth: 6.2% (2010)
→ **3.9% (2011)**

The projected growth of the Korean economy for 2011 was adjusted downward to 3.9%, 0.2 percentage lower than the 4.1% forecast in January 2011 because, despite the positive influence (about +0.6 percentage point) of the U.S. economic recovery, the negative factor (about -0.8 percentage point) associated with sharp international oil and raw material price hikes is expected to be more significant.

Private Consumption:
4.1% (2010) → 3.2%
(2011)

Influenced by worsened purchasing power following interest rate increases and inflationary pressure, private consumption growth is likely to remain at 3.2%, 0.6 percentage point lower than the previously projected 3.8%.

Construction
Investment: -1.4%
(2010) → -3.1% (2011)

Despite the mild 0.6% growth projected earlier, construction investment is now expected to decline due to the housing business slowdown, worsening of construction business management, etc. on top of the approximately 12% decline in the first quarter of this year.

Facility Investment:
25.0% (2010) →
8.3% (2011)

Influenced by base effects, greater uncertainties in corporate investment environments compared with 2010, and other factors, facility investment growth is likely to slow significantly from 2010. Considering the fact that facility investment pressure and average operating ratios are rising again at the start of this year, however, a 0.7 percentage point upward adjustment for facility investment growth was made to 8.3% from the 7.6% forecasted earlier.

Current Account:
US\$28.2 Bil. Surplus
(2010) → US\$12.8 Bil.
Surplus (2011)

Due to import growth outpacing export growth, expansion of service balance deficit, etc., the current account surplus in 2011 is expected to decrease to half the level of 2010. Export growth is likely to slow to 50% of last year due to demand declines following fiscal retrenchment and adjustment of household debt in advanced countries, China's realignment of economic conditions, won-U.S. dollar exchange rate decline and weaker competitiveness in export markets. Influenced by the slowdown in economic growth, import growth also may decline, but is expected to post a higher growth rate than exports owing to a lower foreign exchange rate, unit price hikes, etc. The service balance is likely to continue in deficit due to the low productivity of the Korean service industry and exchange rate declines.

Consumer Prices:
2.9% (2010) → 4.2%
(2011)

A 1.0 percentage point upward adjustment to 4.2% was made in the growth projection for consumer prices compared with the earlier forecast because, with the further worsened price environments since early this year, it will be difficult to improve in the face of a high oil price situation, influenced by the Middle East crises and Japan's earthquakes.

Market Interest Rates:
4.7% (2010) → 4.9%
(2011)

Market interest rates are expected to post only slight growth due to high uncertainties over economic recovery caused by three major risks - fiscal administration problems in Europe, political instability in the Middle East and major earthquakes in Japan, although they may rise, affected by base interest rate and price increases.

Won-U.S. Dollar Fx
Rate: 1,156 (2010) →
1,079 (2011)

The won-U.S. dollar exchange rate is expected to fall due to the current account surplus from the demand side and the higher supply of U.S. dollars with increases in the inflow of foreign capital. Considering the difficult economic situations facing leading countries, however, the downward won-U.S. dollar trend is likely to be limited as the global dollar weakening eases gradually.

Outlook for Korean Economy (2011)

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

| | 2010 | 2011 | | | | | | |
|---------------------------------|--------|--------|--------|--------|--------|--------|--------|--------|
| | Year | 1/4 | 2/4 | 3/4 | 4/4 | 1st H | 2nd H | Year |
| GDP | 6.2 | 4.2 | 3.3 | 3.9 | 4.3 | 3.8 | 4.1 | 3.9 |
| (SA, q-o-q, %) | | 1.4 | 0.8 | 1.2 | 0.9 | 2.0 | 2.1 | |
| Private Consumption | 4.1 | 3.0 | 3.3 | 3.0 | 3.4 | 3.1 | 3.2 | 3.2 |
| Construction Investment | -1.4 | -11.9 | -3.2 | -1.2 | 1.6 | -7.0 | 0.3 | -3.1 |
| Facility Investment | 25.0 | 12.0 | 7.8 | 5.1 | 8.7 | 9.8 | 6.9 | 8.3 |
| Consumer Prices | 2.9 | 4.5 | 4.6 | 3.9 | 3.7 | 4.5 | 3.8 | 4.2 |
| Producer Prices | 3.9 | 6.7 | 8.0 | 7.8 | 6.8 | 7.4 | 7.3 | 7.3 |
| Current Account | 282.1 | 18.5 | 32.7 | 37.4 | 39.2 | 51.2 | 76.6 | 127.8 |
| Commodity | 419.0 | 55.8 | 81.7 | 81.0 | 78.8 | 137.5 | 159.9 | 297.3 |
| Exports (BOP Base) | 4642.9 | 1262.9 | 1361.6 | 1302.0 | 1391.6 | 2624.5 | 2693.6 | 5318.2 |
| Growth (%) | 29.6 | 24.6 | 15.8 | 10.1 | 9.5 | 19.9 | 9.8 | 14.5 |
| Imports (BOP Base) | 4223.8 | 1207.1 | 1279.9 | 212.0 | 1312.8 | 2487.1 | 2533.8 | 5020.8 |
| Growth (%) | 31.9 | 25.0 | 21.5 | 15.5 | 14.4 | 23.2 | 14.9 | 18.9 |
| Service & Others | -136.9 | -37.3 | -49.0 | -43.6 | -39.6 | -86.3 | -83.2 | -169.5 |
| Fx Rate (Avg. KRW/USD) | 1156.5 | 1120.4 | 1080.0 | 1060.0 | 1055.0 | 1100.2 | 1057.5 | 1078.9 |
| Corp. Bonds Yield (3-year, AA-) | 4.7 | 4.6 | 4.8 | 5.1 | 5.3 | 4.7 | 5.2 | 4.9 |
| Unemployment Rate (%) | 3.8 | 4.2 | 3.7 | 3.6 | 3.5 | 4.0 | 3.6 | 3.8 |

Policy Issue:

Necessity to Check Contraction in Private Consumption

Prevention of Slowdown in Private Consumption Recovery

Domestic consumer prices have been increasing sharply since the end of 2010 due to steep hikes in farm, livestock and fishery product prices as well as in international oil and raw material prices. If individual service fees and public utility charges are raised, the across-the-board price increases will work to slow private consumption. Interest rate increases also are expected to be a factor in shrinking private consumption through expansion of interest payment burden in the household economy. Therefore, contraction of private consumption should be prevented through alleviation of household debt and stabilization of the 'Jeonse' market.

House Supply Expansion Policy Harmonized With Market Principle

As the price ceiling system for new apartments is leading to price increases through supply shrinkage in the medium and long term, the policy should be abolished. Furthermore, introduction of a monthly rent and 'Jeonse' ceiling system should be avoided because it may aggravate the instability of the 'Jeonse' market by causing sharp 'Jeonse price hikes' and further stimulating 'Jeonse' demand among those waiting to purchase apartments or houses ahead of implementation of the system.

Adjustment of Household Debt to Stimulate Real Estate Market

Stimulation of the real estate market is necessary to adjust debt for financially weak households and enhance their ability to repay their debts. There is also a need to improve financing systems in a way to more accurately assess the debt repayment capability of households and minimize risks of loan delinquency. Furthermore, continuous monitoring regarding the health of non-banking deposit and lending institutions is required. Since interest rate increases may worsen household economies in the short term, it is also necessary to revamp debt adjustment and bankruptcy policies for low-income and elderly classes having greater financial debt than income.

Political, Diplomatic and Military Preparations for the Contingency in North Korea

Research Monograph 11-02

Lee, Choonkun

Kim Jong Il is trying to evade these hardships through the successful power transition to his younger son Kim Jung Un who is now 27 years old. Most of the North Korean specialists do not believe that the Kim Jung Un has the power and capability to lead North Korea after Kim Jong Il is gone. It is very certain that North Korea will be in a chaotic and lawless situation after the end of the Kim Jong Il regime; this means instability not only in the Korean peninsula, but also in the Northeast Asian international system where the national interests of the four great powers intersect.

To deal with North Korea's contingency effectively, ROK should have a well prepared economic as well as political, diplomatic and military plans to deal with the North Korean contingency.

This report tries to explain why there will be contingency in North Korea and also describe how it will look like. This report should be of guideline for such preparation. This report should be refined and sophisticated further.

Analyzing the effect of opening Korean Medical service market

Research Monograph 11-03

Kang, Sung Won

This paper analyzes the effect of opening Korean Medical service market on production and employment. Using a panel of 25 OECD countries covering 2005–08, this paper estimates the effect of this proposal on production and employment. The result suggests that opening the market by allowing for-profit hospital alone would increase output and employment by 0.3%. Allowing both private medical insurance and for-profit medical practice would increase production and employment by 1.2%.

Legislative Comments on the Supplementary Assessment Method for the better Taxation on the Unlisted Stock

Research Monograph 11-04

Choi, Sung Jai

In case of unlisted stock, it's almost impossible to get the fair and reasonable market price of the stock, because transactions are very rare and most of them are not arms length. By the same token, we have to use a set of assessment tools for the taxation purpose. Under this context, formula based approach as we now adopted in our gift and estate tax law or kinds of assessment techniques such as DCF can be used for the assessment purpose.

Our formula based system has been working smoothly before we encountered a number of derivative lawsuits and criminal cases as follows involving the valuation of unlisted stock. In these cases, Korean Supreme Court rendered its decision that formulae under the tax laws can never be applied to other cases without any modification and the Courts should think it twice for finding fair value of the stock at issue. Fairness now has become the maxim in dealing with the cases as far as derivative lawsuits and criminal cases are concerned.

However, current situation, that is, a single unlisted stock has several market prices, one for tax law purpose and the other for corporation law purpose, is not a efficient and desirable one for both of the regulators and other market participants. In this article by shaping the current formula as legislative alternatives, we try to narrow the gap between those tax and non-tax market price. A series of comments in this article will be helpful for the betterment of our current perplexing moment in the assessment of the unlisted stock at our hands.

www.keri.org

Publisher: Young-Yong Kim
Editor: Pilhyun Kim, Chang-Bae Kim

Designed by Blue-Ribbon Content & Strategy (BCS.Com)
Phone: (82-2) 6258-7870/3 Fax: (82-2) 6258-7877



KERI Economic Bulletin

is published by Korea Economic Research Institute,
8th Fl., Hana Daetoo Bldg., 27-3, Yeouido-dong,
Yeongdeungpo-gu, 150-705 Seoul, Korea.

Tel : (82-2) 3771-0001, FAX : (82-2) 785-0270/1

KERI Economic Bulletin 13