

Monthly Economic Review

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I. Recent Global & Domestic Economic Trends

Major economies

The US economy makes a slow recovery. The ISM Manufacturing Index recorded 54.1 (Jan. 2012) and 54.1 (Feb. 2012) which are above the critical point 50, while the US retail sales increased by a small margin. The unemployment rate continues to show signs of improvement, falling from 8.5% (Dec. 2011) to 8.3% (Jan & Feb. 2012). Building permits have begun to rise, from 682,000 units (Jan. 2012) to 715,000 units (Feb. 2012).

EU plunges into an economic slump. The composite leading indicators of EU stayed below the critical point 100. The retail sales increased by 0.3% and industrial production did by 0.1% in January 2012, compared with those of the previous month.

China maintains a strong economic growth. The Chinese economy grew by about 9% in the fourth quarter of 2011. The industrial production and retail sales sustained signs of solid improvement, recording the growth rate of 11.4% and 14.7% respectively in February, 2012.

Global Financial market

Key stock markets improve, while major currencies send a mixed signal.

Despite the downgrade of Greece's credit rating and the euro-zone's manufacturing slump, the DJIA increased by 2.2%, from 12,952 (Feb. close) to 13,242 (Mar. 26th), in part due to the US economic betterment, including the small dip in its unemployment. Positive signs in the leading economic indices led to an increase of the DAX index by 3.3% (Mar 26th) from the February figures. But the SSE Composite Index showed -3.2% (Mar. 26th) due to the contraction of investment sentiment from the February closing figure.

Owing to the rising concerns over the Japanese fiscal health following the deficit-turned balance of trade in 2011, the Japanese yen against the US dollar depreciated to 82.48 yen (Mar. 26th), a fall from the February close rate. The EUR/USD exchange rate depreciated by 2.8% compared to the last month's close. The CNY/USD exchange rate depreciated by 0.08% due to decrease in foreign direct investment.

Economic indices of major countries

(Unit: %)

		2010	2011					2012		
		Annual	Annual	1/4	2/4	3/4	4/4	Jan	Feb	Mar
United States	Industrial Production	5.3	4.1	1.2	0.2	1.5	0.9	0.4	0.0	-
	Retail Sales	6.4	7.7	2.5	1.2	1.2	1.9	0.6	1.1	-
	DJIA	11,578	-	12,320	12,414	10,913	12,218	12,633	12,952	13,242
European Union	Industrial Production	7.3	3.5	1.0	0.2	0.8	-2.0	0.1	-	-
	Retail Sales	0.8	-0.6	-0.2	-0.4	-0.1	-0.7	0.3	-	-
	DAX	0.8	-	7,041	6,914	5,502	5,898	6,459	6,856	7,079
	EUR/USD	0.752	-	0.708	0.691	0.737	0.772	0.761	0.743	0.764
China	Industrial Production	15.7	13.7	14.9	13.9	13.8	13.8	-	11.4	-
	Retail Sales	18.4	17.1	16.3	17.2	17.3	17.5	-	14.7	-
	SSE Composite Index	2,808	-	2,928	2,762	2,359	2,199	2,293	2,429	2,351
	CHY/USD	6.5897	-	6.5560	6.4634	6.3974	6.3190	6.3337	6.2991	6.3040

Source: US Department of Commerce; Eurostat; The People's Bank of China; Reuters.

Korean Economy

The overall economic growth is hindered as the exports slow down and domestic recovery delays due to the rising uncertainty of the world economy, while the retail sales, facility investments, and construction decline.

In January and February, the Business Survey Indices (BSI) in manufacturing were surveyed to be 79 and 81 respectively, still not recovering to the level of 83 recorded in December 2011. The Composite Leading Indicators (CLI) increased by 0.3%p in February 2012, below the critical point 100.

The retail sales increased by 1.4% in the fourth quarter, showing the margin of growth reduced compared with that of the third quarter. The facility investments and construction continued to decline by 5.4% and 1.1% respectively. The exports in the fourth quarter of 2011 showed a relatively small increase of 10.0% but took an abrupt downturn of 7.0% in January and then a sharp upturn of 22.7% in February 2012.

The inventory/shipping cycle index, which shows the relationship between inventory and shipping, is facing a slowdown after a long decline.

In the financial market, stock prices increase due to continued straight purchases by foreign investors, and both exchange rates and corporate bond yield rates depreciate slightly.

KOSPI decreased by 0.5%, from 2,030 points (Feb. close) to 2,019 (Mar. 26th), due to the negative factors including the regressions in the Euro zone economic indices, stock sales by foreigners, etc.

The domestic stock purchases and bond investments by foreigners have remained steady throughout March.

The KRW/USD exchange rate recorded 1,142 KRW due to the decrease of inflows in foreign capital. The corporate bond yield rates (BBB-) reached 10.13%, a 0.12% p increase compared to the February closing figure.

Korea's major economic indices

(Unit: p, %)

Economic Sector	2010	2011					2012		
	Annual	Annual	1/4	2/4	3/4	4/4	Jan	Feb	Mar
Retail Sales Growth Rate	6.7	4.3	5.4	5.7	4.7	1.9	0.9	-	-
Facility Investment Growth Rate	24.2	0.7	5.4	5.7	-3.1	-4.8	7.8	-	-
Construction Growth Rate	-3.3	-6.7	-12.6	-6.6	-8.4	-0.5	-6.4	-	-
Export Growth Rate	28.3	19.3	29.6	18.7	21.4	10.0	-7.0	22.7	-
Consumer Prices	3.0	4.0	3.8	4.0	4.3	4.0	3.4	3.1	-
Unemployment Rate	3.7	3.4	4.2	3.4	3.1	2.9	3.5	4.2	-
KOSPI	2,051	-	2,107	2,101	1,770	1,826	1,956	2,030	2,019
KRW/Dollar	1,135	-	1,097	1,068	1,178	1,152	1,123	1,123	1,142
Corporate Bond (BBB-)	10.26	-	10.58	10.38	10.24	10.01	10.02	10.01	10.13

Source: Bank of Korea; National Statistical Office.

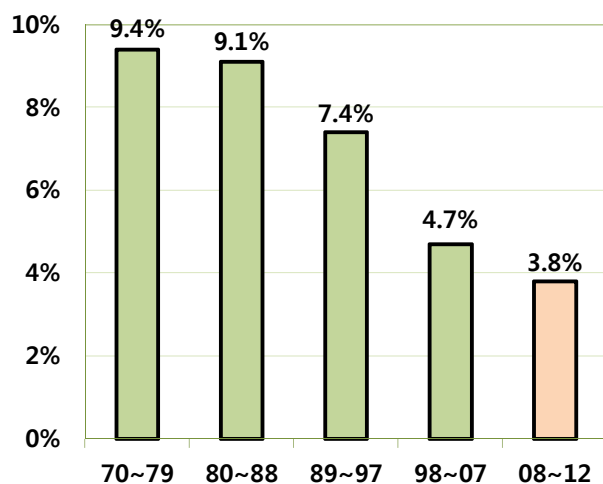
II. Economic Issues facing Korea

Korea's potential growth rate drops to 3% range after the global financial crisis of 2008.

The potential growth rate of the Korean economy plummeted from 4.7%, the average over the period between 1998 and 2007, that from the Asian Financial Crisis to the Global Financial Crisis, to 3.8%, the average over the period between 2008 and 2012, that since the Global Financial Crisis to the present.

In 2011, both the Korea Development Institute (KDI) and the National Assembly Budget Office (NABO), based on the production function approach, estimated the potential growth rate of the Korean economy.¹ KDI calculated a potential growth rate of mid-4% (2001-2007) and a current growth rate of 4.3%. NABO forecasts that the potential growth rate would decline from 4.3% (2004-2007) to 3.7% (2011-2015). OECD's medium/long-term predictions in 2010 indicate that the potential growth rate will decline from 4.0% (2010-2011) to 2.4% (2012-2025) due to Korea's low fertility and aging population.

Potential Growth Rate Development of the Korean Economy **Korea's Potential Growth Rate Development According to Major Institutions**



Source: Hyundai Research Institute.

KDI	Year	1990~1997	2001~2007	2011~2012
	Estimated Figure	mid-6%	mid-4%	4~4.3%
NABO	Year	2004~2007	2006~2010	2011~2015
	Estimated Figure	4.3%	4.0%	3.7%
OECD	Year	2010~2011		2012~2025
	Estimated Figure	4.0%		2.4%

Note: For details, please refer to the reports of the relevant institutions.

The decline in the potential growth rate attribute to the reduced inputs of production factors, weak domestic demand and lack of new leading industries.

The proportion investments taking up in the Korean economy has greatly decreased since the Global Financial Crisis. Contrastingly, the ratio of foreign to domestic investments has sharply increased due to the declining domestic investment returns (marginal productivity of capital), which is natural, and the expanding investment opportunities for foreigners, which is brought about by the rapid development of newly industrialized countries.

The possible reduction of the economically active population in Korea, which seems near at hand, raises an issue of grave concern. The gap between its growth rate and that of the total population is rapidly shrinking. In particular, the aging population works to debilitate the total labor input already.

¹ The figures are calculated using the Hodrick–Prescott (HP) filter. In these studies, the 1980 Oil Shock, the 1988 Seoul Olympics, the 1997 Asian Financial Crisis, and the 2008 Global Financial Crisis have been selected as the major turning points. The data show that those critical moments are highly likely to have caused structural changes in the real GDP data.

The expanding and deepening international division of labor and appreciating raw materials function to reduce the indirect as well as direct value-added effect that trade has traditionally brought about to the Korean economy. In particular, the sudden deterioration in the terms of trade after the mid-1990s has decreased the net benefit of exports also.

Domestic demand fails to act as a safety net for the Korean economy. Its growth rate has always fallen short of that of exports and hardly has the gap narrowed. The lasting emphasis on the export-first development strategy in Korea caused the proportion of domestic consumption in the whole economy to shrink. While the growth contribution made by the Korean exports have maintained an upward trend, that by the consumption and investment are weakening over time.

The new industries hoped to leap the Korean economy forward do not surface yet. The old industries of the 1970s and 1980s are still playing great roles. Korea is in dire need for new growth industries, as the IT industry, a leading industry at present, has been experiencing a gradual decline in its exports in relative terms since 2000.

To prevent a further decline in the potential growth rate, efforts must be continued to secure and strengthen the capital and labor base, heighten the industry, enlarge the domestic demand, and develop new growth industries.

III. The North Korean Issues

The Post-Kim Jong-il Era

While the neighboring countries acquiescing, North Korea quickly moves to succeed Vice Chairman Kim Jong-un to power.

Kim Jong-un, currently the Vice Chairman of the Central Military Commission, has been formally declared as the supreme leader and the successor to the late Kim Jong-il, the Chairman of the National Defense Commission. By showing up at the Kim Jong-Il's memorial ceremony, Kim Jong-un, as the highest ranking member of the Kim Jong-il Funeral Committee and the heir to the so-called Mt. Baekdu bloodline, made his preeminence in power official before the audiences at home as well as abroad. North Korean media praised Kim as the head of the ruling Workers' Party Central Committee (General Secretary of the Workers' Party), the "supreme commander" of the party, military, and people, and the "great successor."

The neighboring countries are acknowledging North Korea's new leadership hoping for the status quo over the Korean peninsula to be sustained. After stating that North Korea must seek stability under the leadership of Comrade Kim Jong-un, Hu Jintao and all of the members of the Politburo Standing Committee of China expressed their condolences for the death of Kim Jong-il and their intent to provide strong support for Kim Jong-un at any cost. Following the airing of a New York television news coverage on the first day of Kim Jong Il's death (Dec 19, 2011) and the release of Secretary of State Hillary Clinton's statement expressing her hope for a peaceful and stable transition of power, a White House representative referred Kim Jong-un as the official successor to Kim Jong-il.

North Korea is widely speculated to maintain stability under Kim Jong-un for at least one year, but medium to long-term stability seems uncertain.

For a year after Kim Jong Il's death, the power structure is expected to remain fixed on Vice Chairman Kim Jong-un, which will operate under the patronage of Kim's advisory group and carry on the "legacy rule", the continuance of the late Kim's policies. In the meantime, it is predicted that the underpinning of the power would shift from the National Defense Commission to the ruling Workers' Party Central Military Commission.

However, the medium and long-term stability relies on the unity within the ruling elites and the public. Especially, how the new regime would cope with its economic difficulty and how North Koreans would respond to it could affect the future. When conflicts within the advisory group, among the hardliners/moderates/liberals or between new/old members of the military occur and the unity is weakened, conflicts are likely to be furthered to foster antagonisms and delays in the process of realizing power and making decisions. Should North Korea's economic woes continue, the popular discontent will be heightened and the support for the new regime lessened, leading more North Koreans to think about social unrest or defect. In turn, it will put the unity of the ruling elites at risk.

Policy Paradigm of the Kim Jong-un Era

In the meanwhile, under the transition of power, the new government will focus on strengthening its internal organization carrying out Kim Jong-il's "legacy rule," pursuing "military-first" politics, to establish a "strong and prosperous state."

Until Kim Jong-un seizes power completely and aligns internal organization sufficiently, the new government will likely maintain its current structure and push forth with the policies of the last administration rather than pursue new ones, including military provocation. After internal reorganization, North Korea is expected to take decisive measures to improve its foreign relations in order to overcome its economic difficulties and induce more foreign aids, with the purpose of gaining public support and securing visible economic improvements. However, there remains a possibility that North Korea will deal with the North-South relationship differently.

Legacy rule is expected to last for one year, not three as in the previous administration.

Military-first politics is indispensable for Kim Jong-un to seize and retain power. Nonetheless, after power transition is thought to be completed as planned, ruling through the Workers' Party could be restored.

The new government could attempt to reopen six-party talks in 2012 to secure foreign aids, improve the US-North Korea relationship and promote its image in the world. North Korea is expected to exercise full discretion in provoking the outside world until diplomatic stability in the Northeast Asian region is re-established.

While the goal of establishing a strong and prosperous state in 2012 is important for North Korea, it is urgent that fundamental changes should be made to resolve the country's economic problems and that a medium to long-term vision be clearly set up in order to maintain the system and lead the people. The new government will embark on reforms attracting foreign capital and improving people's living, though limited in its scope. North Korea is predicted to focus on transforming itself to a knowledge-based economic power and developing its science and technology under the slogan of "High-tech industrialization, Scientification and Globalization," putatively based on the Computerized Numerical Control (CNC) technology propagandized as have been developed under the leadership of Kim Jong-un. In particular, several members of Kim Jong-un's advisory group are showing great interest in inducing foreign capital and enhancing public welfare. Jang Song-taek, who oversaw the construction of 100,000 residences in Pyongyang and the development of Hwanggeumbyeong/Raseon District and visited Seoul in 2002 as a member of the North Korean economic delegation, Kim Kyong-hui, Director of the Light Industry Department, Kim Yang-gun, Chairman of the Daepung Group, and the others are among them. However, some are concerned with that North Korea might become excessively dependent on China politically as well as economically in the process.

How the South Korean government to react will greatly influence the North's future path. The relationship with other countries is expected to remain strained as North Korea maintains its tough stance aiming to strengthen the internal cohesion and contribute to the national image of having a firm leader. South Korea is experiencing difficulty shifting its policy focus away from the Cheonan/Yeonpyeong Island incident. North Korea will likely continue to raise tensions against South as a part of maintaining control within the regime and managing risk to appease internal discontent. Furthermore, as South Korea failed to fulfill the North-South Joint Declaration under the current regime, new conflict might occur between the two Koreas when the South Korean government does not offer an alternative in the future.

Outlook of Vice Chairman Kim Jong-un's Policies for Kim Jong-il's "Legacy Rule"

	Direction	Details
Politics	Military-first politics	<ul style="list-style-type: none"> •Maintaining a military and ruling party-oriented power structure (with Kim Jong-un's appointment to the Chairman of the Workers' Party Central Military Commission)
Economy	Becoming a strong and prosperous state	<ul style="list-style-type: none"> •Attracting foreign capital, expanding China-North Korea economic cooperation (including the development of Hwanggeumyeong and Raseon District) •Implementing a ten-year national economic development plan •Expanding social overhead capital (particularly, agriculture, energy, logistics, parks, railroads, roads, etc.) •Improving public welfare, advancing science and technology, constructing 100,000 residences in Pyongyang, the capital, etc. •Establishing a self-reliant national economy (by creating major production systems for steel, fertilizers, fibers, etc.)
Nuclear	Denuclearization of the Korean Peninsula	<ul style="list-style-type: none"> •Asserting its status as a nuclear state and requesting security assurances in return for nuclear disarmament •Reopening six-party talks and claiming peaceful nuclear programs (including the construction of light-water reactor)
Foreign Relations	Practical diplomacy	<ul style="list-style-type: none"> •Deepening North Korea's reliance on China •Trying to normalize the US-North Korea relationship •Pursuing a practical, tug-of-war diplomacy with China/Russia
North-South Korea Relations	To sign a peace treaty and execute the terms agreed upon in the North-South Joint Declaration	<ul style="list-style-type: none"> •Attempting to reduce strain between the North/South in the competition for superiority in leadership over the Korean Peninsula •Advancing national projects (especially, development of the Mount Kumgang and the Kaesong Industrial Complex) through economic cooperation with the South

Implications for South Korea

The year of 2012 will be marked as a transitional period and to that extent, an opportunity to ensure the stable management over the Korean Peninsula and establish a new direction for the North-South relationship.

South Korea will approach the inter-Korean matters as not only an immediate party to the issues of the Korean Peninsula but also a proponent of their solutions. Amidst the signs that the United States and China acknowledged the North's new leadership and are attempting actively to make contact with the latter since then, South Korea must take caution so as to prevent its interests from being marginalized in the process while still mired in the aftermath of the Cheonan/Yeonpyeong Island incident. In particular, a practical and balanced diplomacy to strengthen the South Korea-US relationship as well as deepen the strategic partnership with China is required, while South Korea is guarding against the possibility for North to become heavily reliant on China economically and politically. South Korea should seek a way to support the soft-landing of the new North Korean regime and furnish an atmosphere for the latter to feel comfortable in making a new North-South relationship and implementing reform and openness. To this end, South Korea will need engage in forward-looking talks on non-political and military issues, economic cooperation between the two Koreas, South's humanitarian aids to North, the reunion of separated families, etc., disregarding how the Cheonan/Yeonpyeong Island incident would be dealt with.

[Annex] Domestic and Global Economic Indices

Domestic/Global Growth Rate

Category	2010					2011					2012
	Annual	1/4	2/4	3/4	4/4	Annual	1/4	2/4	3/4	4/4	Annual (E)
United States	3.0	3.9	3.7	2.5	2.3	1.7	0.4	1.3	1.8	3.0	1.8
Euro Area	1.8	0.4	1.0	0.4	0.3	1.4	0.8	0.2	0.1	-1.3	-0.5
Japan	4.4	6.1	5.2	2.3	-0.6	-0.9	-6.8	-1.5	7.0	-2.3	1.7
China	10.3	11.9	11.1	10.6	9.8	9.2	9.7	9.5	9.1	8.9	8.2
Korea	6.2	8.5	7.5	4.4	4.7	3.6	4.2	3.4	3.5	3.4	4.0

Note: 1) For 2012 global projections, January 2012 IMF figures; For 2012 Korean projections, Hyundai Research Institute.

2) For the United States and Japan, their annual rates were compared to those of the previous term, for the euro-area, to the rates of the previous term, and for China and Korea, to those of the same term in the previous year.

International Finance Index

Category		2010 Close	2011		2012		Previous-day Change
			End of Jun.	End of Dec.	Mar.23	Mar. 26	
Overseas	Ten-year U.S. Treasury Bond Interest Rates (%)	3.30	3.16	1.88	2.24	2.29	-0.05%p
	JPY/USD	81.19	80.66	77.66	82.62	82.48	-0.14¥
	USD/EUR	1.3350	1.4492	1.2955	1.3197	1.3280	0.0083\$
	DJIA (p)	11,578	12,414	12,218	13,081	13,242	161p
	Nikkei (p)	10,229	9,817	8,455	10,011	10,018	7p
Domestic	Three-year government bond interest rates (%)	3.38	3.76	3.34	3.64	3.62	-0.02%p
	KRW/USD (KRW)	1,134.8	1,067.7	1,151.8	1,135.3	1,141.6	6.3 KRW
	KOSPI (p)	2,051.0	2,100.7	1,825.7	2,026.8	2,019.2	-7.6p

International Raw Materials Price Index

Category		2010 Close	2011		2012		Previous-day Change
			Jun. Close	Dec. Close	Mar. 23	Mar. 26	
International Oil Prices	WTI	91.40	95.18	99.22	106.68	107.15	0.47\$
	Dubai	88.80	106.75	104.89	122.18	122.91	0.73\$
CRB futures indices		332.80	338.05	305.30	314.47	315.01	0.54p

Note: The CRB index is calculated by giving the same weight to the prices of a total of 19 major commodities such as grains, crude oil, raw materials for industry, and precious metals. The index provides an international standard for the price of raw materials.



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