

# HRI Monthly Economic Review

- I . Recent Economic Trends
- II . Economic Issues Facing Korea
- III . The North Korean Issues
- [Annex] Domestic and Global Economic Indices

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Devoting to economic research  
and human resource development  
with intellectual conscience and sincerity,  
the Hyundai Research Institute leads  
the advancement of Korean Economy  
in the 21st century by proposing  
creative policy alternatives.

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## < Executive Summary >

### I . Recent Economic Trends

The economies of the US and the Eurozone continue to recover while the economic recovery of Japan and China appears to be slowing down. In terms of Korea, although production and consumption decreased, investment increased. Exports marginally fell and inflation remained below 2% for the 19th consecutive month.

### II . Economic Issues Facing Korea

#### 『Estimation of Equilibrium Exchange Rate of KRW/USD』

The KRW/USD exchange rate sharply fell by over 4% in one month to 1,030s won to 1 dollar, marking at 1,032 on 29th April 2014, the lowest rate of the year. The KRW/USD exchange rate is falling faster compared with exchange rates of other major Asian economies' currencies to the US dollar. Unlike the IMF's view that the Korean won has been undervalued by about 8%, estimation of the long-term equilibrium level by real effective exchange rate and behavioral equilibrium exchange rate shows that the KRW/USD exchange rate unduly dropped as the won was analyzed to have been overvalued by 5% to 6%.

#### 『Estimation of ‘Households Capable of Purchasing a House’ and Suggestions』

‘Households capable of purchasing a house’ refers to households that can afford to buy a house at an actual transaction price with financial assets in possession plus a reasonable amount of mortgage loan from a bank. The number of households capable of purchasing a house as of 2013 accounted for 5.687 million, 31.3% of the total number of households. The number of households capable of buying a house increased by 9.0% during the period of 2012-2013, which is in contrast to the number of remaining households decreasing by 1.7%.

### III . The North Korean Issues

The unification of Korea will bring about a qualitative change to the infrastructure of national economic activity, creating an opportunity for new growth engine. Post-unified Korea is forecast to transform itself from a virtual island nation to a continental economic nation securing a domestic market for economy of scale, and from a resource-poor country to a resource-rich country. The combination of cutting edge technology and highly efficient labor will enable a unified Korea to re-emerge as “the world’s factory” with industry life cycle extended, achieving a growth equivalent to quantum leap.

## I . Recent Economic Trends

### 1. Recent Global & Domestic Economic Trends

#### Major Foreign Economies

*The economies of the US and the Eurozone continue to recover while the economic recovery of Japan and China appears to be slowing down.*

The US is maintaining its economic recovery. Although the economic growth rate(provisional) in the first quarter of 2014 showed a quarter-on-quarter drop of 1.0%, this is attributed to inventory decreasing. Considering businesses sold existing stock as consumption shrank due to the effects of the cold weather wave, US economic recovery is expected to gain force as consumption improves. Although industrial production in April recorded a month-on-month drop of 0.6%, manufacturing industry's PMI increased from 54.9p in April to 55.4p in May. Unemployment is on the decline and the number of the newly-employed shows a stable increase.

The Eurozone's economy shows a weak sign of recovery. Economic growth in the first quarter of 2014 recorded a quarter-on-quarter rise of 0.2% and a year-on-year rise of 0.9%, the highest year-on-year increase since 1.4% in the third quarter of 2011. Retail sales in April marked a month-on-month increase of 0.4%, and consumer confidence index in May was 102.8p, a month-on-month rise of 0.8p. Industrial production in March, however, recorded a month-on-month drop of 0.3%, and manufacturing industry's PMI marked 52.2p, a month-on-month drop of 1.2p.

Japan's economic recovery appears to suffer a temporary setback due to the consumption tax increase. Both industrial production and retail sales in April

showed a month-on-month fall of 2.5% and 13.7% respectively. Manufacturing industry's PMI shows a modest recovery marking 49.4p in April and 49.9p in May. The year-on-year growth rate of imports accounted for 18.1% in March and 3.4% in April, showing a shrinking domestic demand.

China's economic recovery shows some sign of slowing down. Industrial production in April recorded a year-on-year rise of 8.7%, the lowest since 7.3% recorded in April 2009. Retail sales in April marked a year-on-year rise of 11.9%, lower than the March figure by 0.3%p. Fixed asset investment in April showed a year-on-year increase of 17.6%, lower than the March figure by 0.3%p. The year-on-year export growth rate rallied from minus 6.6% in March to plus 0.9% in April, a modest recovery.

Stock markets of major economies in May showed a strong positive trend thanks to expectation for the upcoming economic recovery of advanced countries including the US and the political unrest of Ukraine calming down.

### < Economic Indices of Major Countries >

(% )

(p, yen, euro, yuan)

Economic Sectors	2012	2013	2014			Economic Sectors	2012	2013	2014				
	Annual	Annual	Feb	Mar	Apr		Annual	Annual	Apr	May			
US	Industrial Production	3.8	2.9	1.1	0.9	-0.6	Stock index	DJIA	13,104	16,577	16,581	16,717	16,744
	Retail Sales	5.1	4.2	0.9	1.5	0.1		DAX	7,612	9,552	9,603	9,943	9,950
EU	Industrial Production	-2.5	-0.7	0.2	-0.3	-		NIKEI	10,395	16,291	14,304	14,632	14,936
	Retail Sales	-1.7	-0.8	0.2	0.1	0.4		SSE	2,269	2,098	2,026	2,039	2,039
Japan	Industrial Production	0.6	-0.8	-2.3	0.7	-2.5	Rate of Exchange	EUR/USD	1.3222	1.3799	1.3812	1.3602	1.3625
	Retail Sales	1.8	1.0	0.3	6.4	-13.7		YEN/USD	85.86	105.04	102.63	101.74	101.83
China	Industrial Production	10.0	9.7	8.6	8.8	8.7		CNY/USD	6.2317	6.0617	6.2580	6.2380	6.2479
	Retail Sales	14.3	13.1	11.8	12.2	11.9							

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

Note : US, EU, Japan QoQ, China YoY

## 2. Korean Economy

*Although production and consumption decreased, investment increased. Exports marginally fell and inflation remained below 2% for the 19th consecutive month.*

Investment increased while production and consumption dropped. Production in April showed a month-on-month fall of 0.5% with service industry output falling despite a marginal increase in construction, mining and manufacturing industries. Consumption recorded a month-on-month drop of 1.7% due to a shrinking of consumer sentiment caused by the Saiwol ferry disaster. Facility investment in April marked a month-on-month rise of 2.6%, and constructions showed an increase of 6.9% in the same month.

Exports in May amounted to US\$47.9 billion, a year-on-year drop of 0.9% due to the reduced working days following the voluntary decision of businesses to reduce work place operation. Imports in May, however, recorded US\$42.5 billion, a year-on-year rise of 0.3% and a trade surplus for the 28th consecutive month of US\$5.4 billion.

Total number of employees in April accounted for 25.7 million, a year-on-year rise of 581.0 thousand. The employment rate in April marked 60.6%, a year-on-year rise of 0.8p, while the unemployment rate recorded 3.9% in April, a year-on-year rise of 0.7p, due to the increasing job-seeking activities by the economically inactive population.

Consumer price inflation showed a year-on-year rise of 1.7% and a month-on-month rise of 0.2%. The year-on-year growth rate of 1.7% is the highest change since 2.1% recorded in October 2012. Nevertheless, these figures are still well below the 2.5%-3.5% target set by the Bank of Korea.

The KRW/USD exchange rate maintained its falling trend in May owing to the sustained trade surplus and buying pressure by foreign capital investment.

## &lt; Korea Major Economic Indices &gt;

(p, %)

Economic Sectors		2011			2012					2013					2014	
		Annual	3/4	4/4	Annual	1/4	2/4	3/4	4/4	Annual	1/4	2/4	3/4	4/4	Apr	May
Domestic Market	Retail Sales	4.5	0.7	-0.5	2.3	1.1	0.2	1.4	-0.1	0.7	-1.0	0.9	0.8	0.4	-1.7	-
	Facility Investment Index	4.0	1.7	-3.6	-2.0	5.6	-6.2	-3.7	0.4	-5.0	-3.1	1.1	5.0	5.9	2.6	-
	Construction	-6.4	-4.5	3.2	-5.8	-5.0	-1.7	1.9	1.7	10.5	3.5	6.3	-0.1	-0.7	6.9	-
Foreign Trade	Export Growth Rate	19.0	21.4	9.0	-1.3	2.9	-1.7	-5.8	-0.4	2.2	0.4	0.7	2.7	4.8	9.0	-0.9
Employment/ Prices	Unemployment Rate	3.4	3.1	2.9	3.2	3.8	3.3	3.0	2.8	3.1	3.6	3.1	3.0	2.8	3.9	-
	Consumer Price	4.0	4.3	4.0	2.2	3.0	2.4	1.6	1.7	1.3	1.6	1.2	1.4	1.1	1.5	1.7
Finance	KOSPI	-	1,770	1,826	-	2,014	1,854	1,996	1,997	-	2,005	1,863	1,997	2,011	1,959	1,995
	KRW/USD	-	1,178	1,152	-	1,133	1,145	1,111	1,071	-	1,111	1,142	1,075	1,067	1,030	1,020
	3yr Government Bond	-	3.55	3.34	-	3.55	3.30	2.79	2.82	-	2.52	2.88	2.82	2.86	2.86	2.82
	Corporate Bond (BBB-)	-	10.31	10.12	-	10.05	9.69	8.69	8.81	-	8.50	8.99	8.97	9.10	9.10	9.04

Source : Bank of Korea, National Office of Statistics, Foreign Trade Association.



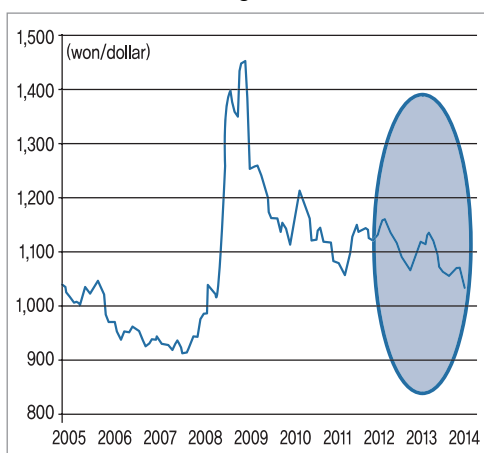
## II . Economic Issues Facing Korea

### 1. Estimation of Equilibrium Exchange Rate of KRW/USD

#### Recent Trend of KRW/USD Exchange Rate

The KRW/USD exchange rate sharply fell by over 4% in one month to 1,030s won to 1 dollar, marking at 1,032 on 29th April 2014, the lowest rate of the year. The KRW/USD exchange rate is falling faster compared with exchange rates of other major Asian economies' currencies to the US dollar. Discussions on the equilibrium KRW/USD exchange rate are expanding as the IMF is of the opinion that the KRW/USD exchange rate should further drop. This report, therefore, analyzes the gap if any between the recent KRW/USD exchange rate movements and the equilibrium rate by estimating equilibrium exchange rate in two folds: real effective exchange rate and behavioral equilibrium exchange rate.

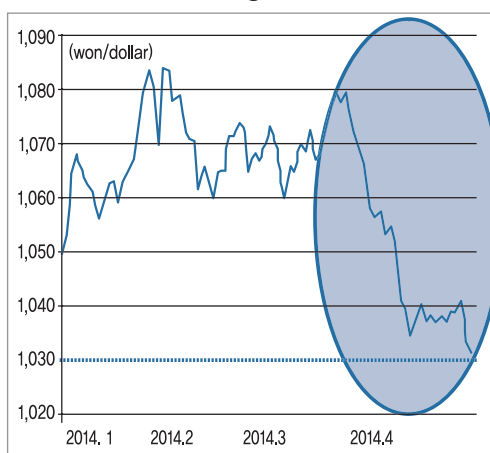
<Long-term Trend of KRW/USD Exchange Rate>



Source :The Bank of Korea.

Note : Based on monthly average closing exchange rate of KRW/USD.

<Latest Trend of KRW/USD Exchange Rate>

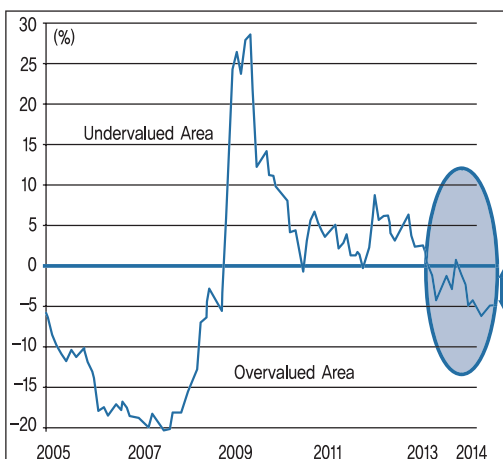


Source :The Bank of Korea.

Note : Based on daily average closing exchange rate of KRW/USD.

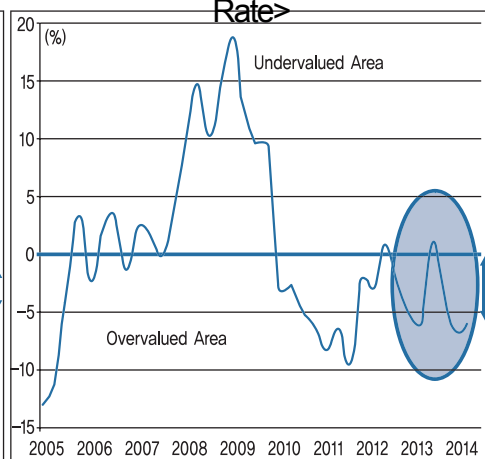
Based on the theory of purchasing parity, the real effective exchange rate is estimated by calculating a weighted average of real exchange rates with prices of major trading partner countries taken into consideration and weighted values according to their value of trade. The real effective exchange rate reflects relative fluctuations of prices and nominal exchange rates between trading countries, and applies the fluctuations of real purchasing powers following the price change to the real exchange rate. The result of reviewing the long-run equilibrium level based on real effective exchange rate shows that KRW/USD exchange rate was overvalued by 4.8% as of March 2014. Behavioral equilibrium exchange rate estimates equilibrium exchange rate by using economic fundamentals that affect fluctuations of exchange rate. Movements of real exchange rate was estimated by utilizing government debt ratio as a risk premium and by setting terms of trade ratio, tradable goods to non-tradable goods ratio, and net foreign asset ratio as control variables. The result of comparing long-run equilibrium level based on behavioral equilibrium exchange rate reveals that KRW/USD exchange rate was overvalued by 6.1% as of the first quarter of 2014.

<Estimated Disparate Ratio to Long-run Equilibrium Based on Real Effective Exchange Rate>



Note: 1) Disparate ratio(%)=[(real exchange rate/equilibrium exchange rate)-1]\*100.  
 2) Estimated by Hyundai Research Institute based on monthly data.

<Estimated Disparate Ratio to Long-run Equilibrium Based on Behavioral Equilibrium Exchange Rate>



Note : 1) Disparate ratio(%)=[(real exchange rate/equilibrium exchange rate)-1]\*100.  
 2) Estimated by Hyundai Research Institute based on monthly data.

### *Policy Suggestion*

Unlike the IMF's view that the Korean won has been undervalued by about 8%, estimation of the long-term equilibrium level by real effective exchange rate and behavioral equilibrium exchange rate shows that the KRW/USD exchange rate unduly dropped as the won was analyzed to have been overvalued by 5% to 6%. Also, the gap with equilibrium level is feared to widen as the falling trend of exchange rate accelerates in April. The government therefore needs to strengthen monitoring of fluctuations of foreign exchange demand & supply and movements of short-term capital, and set up a stable and effective exchange rate policy to prevent widening a gap between exchange rate and long-run equilibrium exchange rate. When the real exchange rate persistently diverges from the long-run equilibrium exchange rate, it can affect the real economy as exchange rate volatility expands and adjusts. In the case that the KRW/USD exchange rate continues to fall, the profitability of export businesses is feared to deteriorate rendering exports depressed, and therefore, export businesses are urged to prepare appropriate countermeasures to enhance competitive edge and explore new markets.

## **2. Estimation of 'Households Capable of Purchasing a House' and Suggestions**

### *Depressed Housing Market and Estimation of Potential House Buyers*

Depression of housing market is continuing. Characteristics of housing market need to be analyzed and potential house buyers, in other words, 'households capable of purchasing a house' should be estimated to revitalize the sluggish housing market.

### *Characteristics and Estimation of 'Households Capable of Purchasing a House'*

**(Definition and Estimation)** 'Households capable of purchasing a house' refers to households that can afford to buy a house at an actual transaction price with financial assets in possession plus a reasonable amount of mortgage

loan from a bank. The number of households capable of purchasing a house as of 2013 accounted for 5.687 million, 31.3% of the total number of households. It is estimated that out of 5.687 million households, 1.439 million households are living in rented properties while 4.248 million households are owner-occupiers. The number of households capable of buying a house increased by 9.0% during the period of 2012-2013(5.218 million→5.687 million households), which is in contrast to the number of remaining households decreasing by 1.7%(12.666 million→12.454 million households).

**(Characteristics of Households Capable of Purchasing a House)**

The typical households capable of purchasing a house are mainly families in the middle/high income bracket living in their own house or rented property in non-capital region. 65% of the households capable of purchasing a house are in non-capital region where the price of property is cheaper, 60.9% are living in their own houses, and 28.2% are living in rented properties. 84.7% are married couples, 52.0% are middle-class, and 44.8% are high-income earners.

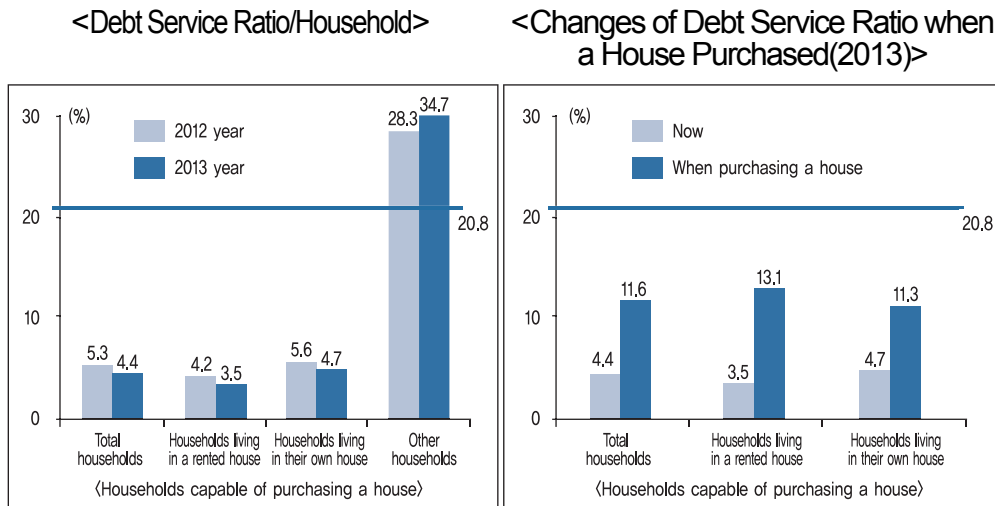
<Major Characteristics of ‘Households Capable of Purchasing House’>

Division	Characteristics	Distribution
Regions	Non-capital region > Capital region	Non-capital region 65.5%
Residence Type	Own House, Deposit-based Lease > Deposit-based monthly rent, Monthly rent, Others	Own house 60.9%, Deposit-based lease 28.2%
Marital Status	Married(couple living together) > Single, Bereaved, Divorced	Married 84.7%
Income Level	Middle class, High-income earners > Low-income group	Middle class & High-income earners 96.8%

**(Change of Financial Structure Before and After Purchase of House)**

Households capable of purchasing a house have a financial structure strong enough not to be burdened for the debt repayment. The debt service ratio (mortgage amount/disposable income) of households capable of purchasing a house accounted for 4.4% in 2013, notably lower than 34.7% of other households. Although the debt service ratio will rise from 4.4% to 11.6% when

these households purchase a house, it is still much lower than 20.8%, the debt service ratio that can make debtors start feeling burdened for debt repayment. In the meantime, the debt service ratio of households living in a rented property will rise from 3.5% to 13.1%, and the debt service ratio of households with their own house will increase from 4.7% to 11.3% when purchasing a house.



Source : Estimated by Hyundai Research Institute based on micro-data(Survey on households financial welfare) of the National Statistical Office.

Note : Diagram on the right shows changes of debt service ratio when 'households capable of purchasing a house' buy a house.

### Suggestions

Out of 5.687 million households capable of purchasing a house, 55.8% appear to be prepared to invest in real estate when extra cash is available, suggesting that these potential buyers can positively contribute to the housing market if system and policy support are available. Appropriate support should be provided to the first-time buyers living in rented property so that they can change their type of residence from rented property to their own house while encouraging those living in their own house to buy a second house for rental income. Positive consideration to reduce tax for those buying newly-built or unsold houses for the purpose of inheritance or gift should be made. It is also recommended to increase capability to purchase a house by expanding low-interest shared mortgage service.

## III. North Korean Issues

### 1. Twelve Promising Industries after Unification of Korea

#### *Change of Economic Activity Infrastructure Following Unification of Korea*

The unification of Korea will bring about a qualitative change to the infrastructure of national economic activity, creating an opportunity for new growth engine.

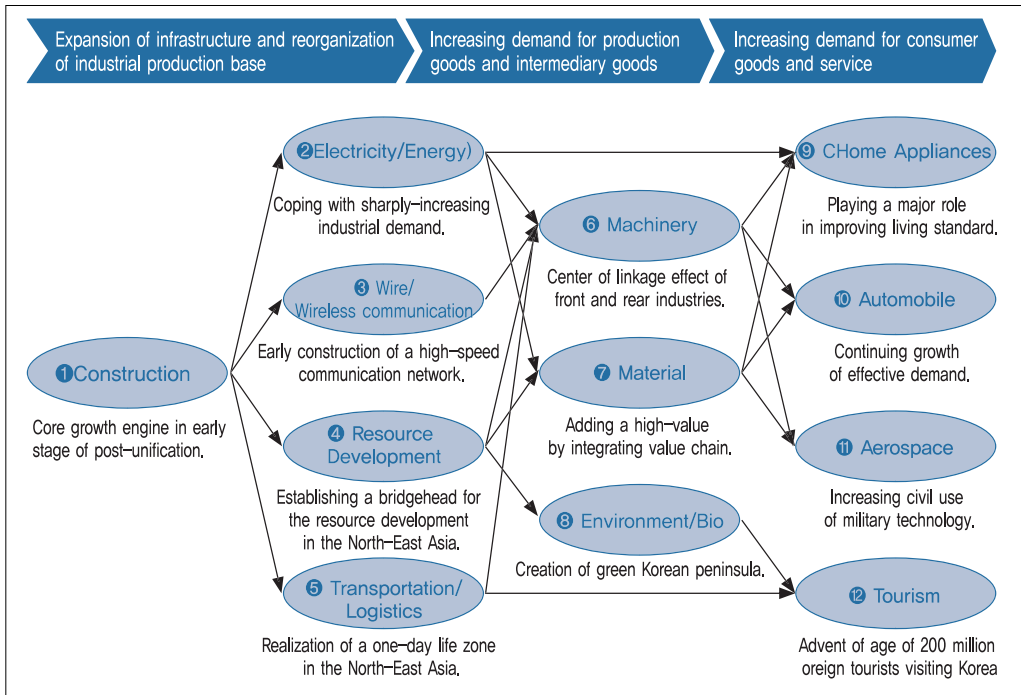
Post-unified Korea is forecast to transform itself from a virtual island nation to a continental economic nation securing a domestic market for economy of scale, and from a resource-poor country to a resource-rich country. The combination of cutting edge technology and highly efficient labor will enable a unified Korea to re-emerge as “the world’s factory” with industry life cycle extended, achieving a growth equivalent to quantum leap. The defense budget will be cut and military technologies are expected to be transferred to dual-use technology.

#### *Post-unification Industrial Development Paths*

With unification, Korea is forecast to enter a new path for industrial development and a number of Korean industries will enjoy a second renaissance. Infrastructure-related industries are forecast to develop fast during the early stage of a government-led planned development when groundwork for economic growth is established in earnest by expanding infrastructure for production facilities and by reorganizing cities and industrial complexes. Once infrastructure and energy issues are solved, production goods and intermediary goods industries are expected to grow fast with private capital and technology of South Korea combined with natural resources

and labors of North Korea. Also, consumer goods and service industries are anticipated to grow with the potential demand turning to effective demand as employment and income increase.

<Post-unification Industrial Development Paths and 12 Major Promising Industries>



Source : Hyundai Research Institute

*Post-unification Industrial Development Paths and 12 Major Promising Industries of Korea*

1. Construction: Construction industry will emerge as a core growth engine for the early stage of unification of Korea with the growing demand for expanding infrastructure and constructing industrial complexes and urban development.

2. Electricity/Energy: Power generating units will be expanded fast to cope with sharply-increasing power demand while energy production in North Korea will also increase rapidly.
3. Information Technology: The combination of information technology-strong S. Korea and second mover N. Korea will establish a super-highway communication network using cutting edge technology in a short period time.
4. Natural Resource Development: An industrial complex for mining, metallurgy, and energy is expected to be built in the north-eastern region of Korean peninsula to utilize in the long term as an advance base to develop natural resources in Russia and Mongolia.
5. Transportation/Logistics: High-speed railway will shrink the entire Korean peninsula and Northeast Asia into a one-day life zone and will make Korean peninsula a distribution center of Eastern Eurasia when the Silk Road Express(SRX) is complete.
6. Machinery: Machinery industry is expected to re-enter the high-growth period with rapidly increasing demand for production facilities in all industries.
7. Materials Industry: Integration of the value chain of up and downstream industries of materials industry is expected to secure competitive edge both in price and technology and lead Korea to establish itself as a materials-strong nation.
8. Environment/Bio: Creation of green Korean peninsula utilizing Clean Development Mechanism(CDM) and establishment of inter-complementary system for agro-fishery industries is expected to prompt eco, environment, and bio industries to develop rapidly.
9. Home Appliances: Demand for home appliances is forecast to increase sharply with domestic market growing thanks to rising income. The competitive edge of home appliances made in Korea is expected to be enhanced with differentiated division of labor throughout northern and southern Korea.



10. **Automobile Industry:** The motorcar industry has a great ripple effect on both upstream and downstream industries and is expected to continue to grow with domestic market and the markets of the three provinces in Northeast China as a stepping stone.
11. **Aerospace Industry:** Aerospace industry is anticipated to develop fast as the civil use of military technology is promoted with defense budget cut following the global armament race reduced or settled.
12. **Tourism Industry:** It is forecast that the number of foreign tourists visiting Korea is anticipated to reach maximum 200 million in 2050 with its turnover amounting up to US\$250 billion thanks to the tourism market expanding to North Korea, China, Southeast Asia, Russia, and European countries.

### *Policy Suggestions*

To make unification come to a being, and not a dream, elaborate preparation should be made in advance in many areas including developing a bond of sympathy and building trust between the two Koreas, sharing development strategy and action plan, and securing political and economic driving force:

1. Active and serious effort should be made in earnest between the two Koreas involving government agencies as well as private organizations to form a bond of sympathy towards unification and prosperity to follow.
2. A roadmap and action plan for different scenarios for the development of 12 post-unification major promising industries should be set up to reduce the cost for unification and to maximize the advantage coming from unification.
3. Government should focus on maintaining consistency of unification policy to secure the political and economic driving force.

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**[Annex]**  
**Domestic and Global Economic Indices**

## [Annex] Domestic and Global Economic Indices

### □ Global Growth Rate

Category	2012					2013					2014
	Annual	1/4	2/4	3/4	4/4	Annual(E)	1/4	2/4	3/4	4/4	Annual(E)
US	2.8	3.7	1.2	2.8	0.1	1.9	1.1	2.5	4.1	2.6	2.8
Euro Region	-0.6	-0.1	-0.3	-0.1	-0.5	-0.4	-0.2	0.3	0.1	0.3	1.2
Japan	2.0	3.7	-1.7	-3.1	-0.2	1.7	4.8	3.9	1.1	1.0	1.4
China	7.7	8.1	7.6	7.4	7.9	7.7	7.7	7.5	7.8	7.7	7.5

Note: 1) IMF figures of April 2014 for 2013 and 2014 global projections.

2) Annual rates were compared with those of previous term for the US and Japan, with the rates of the previous term for Euro region, and with the same term in the previous year for China.

### □ Economic Indicators of South Korea

Division		2012	2013			2014(E)
			the first half	the second half	Annual	
National Account	Economic Growth rate (%)	2.3	2.4	3.5	3.0	3.8
	Private Consumption (%)	1.9	1.9	2.1	2.0	2.7
	Construction Investment (%)	-3.9	6.4	7.0	6.7	2.5
	Facility Investment (%)	0.1	-8.3	6.2	-1.5	6.7
Foreign Trade	Current Account (100 million Dollars)	508	313	486	799	490
	Exports (100 million Dollars) [Increase rate, %]	5,479 [-1.3]	2,765 [0.5]	2,832 [3.8]	5,596 [2.1]	6,067 [8.4]
	Imports (100 million Dollars) [Increase rate, %]	5,196 [-0.9]	2,565 [-2.9]	2,591 [1.4]	5,156 [-0.8]	5,697 [10.5]
Consumer Price (Average, %)		2.2	1.4	1.2	1.3	2.4
Unemployment rate (Average, %)		3.2	3.4	2.9	3.1	3.1

### □ Economic Indicators of North Korea

		2005	2006	2007	2008	2009	2010	2011	2012	2013
Per capita GNI (10, 000 won)		105	103	104	114	119	124	133	137	-
Amount of Trade by Year (USD million)	South-to-North	715.5	830.2	1,032.6	888.1	744.8	868.3	800.2	897.2	520.6
	North-to-South	340.3	519.5	765.3	932.3	934.3	1,043.9	913.7	1,074.0	615.2
	Total	1,055.8	1,349.7	1,797.9	1,820.4	1,679.1	1,912.2	1,713.9	1,971.2	1,135.8

Source : THE BANK OF KOREA, Ministry of Unification

# Hyundai Research Institute

## Current Status

HRI is established by Chung Ju-yung, the first CEO, founder and honorary chairman of Hyundai Group in 1986. HRI is a leading Korean research think tank committed to studying and analyzing the economic and industrial environment as well as reunification economy of Korea. HRI, further, has its own businesses such as business consulting, education and training service, and knowledge-content business.

## Main Research Topics

HRI is mainly composed of four divisions. The major working areas of each part are as following :

**Research Sector** deals with the macroeconomic issues relating to domestic-and-international economy as well as the industrial trends and issues. Reunification Economy Center is one of its sub-sectors, specialized in both the North Korean political and economic issues.

**Business Consulting Sector** devotes to helping domestic and international companies improve their competitiveness by providing strategic solutions.

**Knowledge-Business Sector** produces a great deal of invaluable online-and-offline contents such as educational videos and reading materials.

**Human Resource Development and Education Sector** provides HR development consulting services to companies for improved talent management, and also provides educational services such as training and lectures.

## Messages to Future-Cooperation Partner

HRI is prepared for cooperation and coworks with your institute, especially in the field of survey, economic trend analysis and business consulting. For more information on cooperation, please contact us.

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 **Hyundai Research Institute**

