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Contents

Solid growth through free market and social reconciliation

- The 2007 Korea Economic Outlook -

< Executive Summary >	i
I. Korean economy faced with transitional crisis	1
□ Drop in productivity due to dilapidation of social system	1
□ Foundation for of advanced economy established through growth, free market, and reconciliation	3
II. Deepening gap between major economic indicators and market-sensed economic situation - Key characteristics of the Korean economy in 2006	5
□ Slowdown in GNI and rise in commodity prices	6
□ Decrease in surplus from foreign trades	1
□ Greater instability in financial market	21
□ Inability to get out of low-growth trap	51
III. Changes in economic conditions causing concern about undesirable internal and external factors - Prospects of conditions in 2007	9
(External conditions)	9
□ Global recession	9
□ Worsening trade environment	2
□ Concerns about the probable global inflation triggered by China	4

(Internal conditions) 2

- Increase in foreign exchange risk caused by volatility of Won's value 2
- Crisis caused by North Korea's nuke program and geopolitical risks 2
- Political economic situation in connection with Presidential election 2

IV. Domestic economy experiencing difficulties in escaping the low-growth trap

- Forecast on the domestic economy in 2007 2
- Slowdown in both domestic consumption and exports 2
- Higher volatility in financial market 3
- Big difference in briskness by sector 3
- Contraction in inter-Korean economic cooperation 4

V. Five major issues related to domestic economy in 2007 - with focus on the Government's policy measures 5

- Continued low growth/ crisis situation related to household debts 5
- Unease in foreign exchange market and current account deficit 3
- Increased fear of burst of real estate bubble 4
- Worsening economic sentiment due to unstable political situation surrounding the Korean Peninsula 7
- Popularity-conscious policies associated with Presidential election 8

VI. Laying firm foundation for economic advancement focusing on growth, market, and reconciliation 6

- Growth, free market, and reconciliation should be policy keywords of the Government in New Year 6
- Innovation of socioeconomic system 6
- Pursuit of innovations for creative education 8
- Establishment of new values 7

< Appendix > 72

< Executive Summary >

○ Gap between economic indicators and market-sensed economic situation

In 2006, the Korean economy posted a relatively high economic growth (i.e. approximately 5 percent) in terms of GDP(Gross Domestic Product), which focuses on production activities. However, the gap between major economic indicators and market-sensed economic situation has deepened amid the anemic growth of GNI(Gross National Income) accompanying the market situation contradicting positive economic indicators. In 2006, the nation's economy exhibited the following four features.

First, the economy showed a growth rate higher than that of the preceding year from a macroeconomic viewpoint. However, the market activities lost steam, while GNI showed an anemic growth and commodity prices rose. The consumption sector, accounting for about half of GDP, failed to get out of the trap of a low growth, which worked against the increase in the number of new jobs. People's real income stayed stagnant as foreign trade conditions worsened due to the jump in international oil prices. The sharp increase in household debts put a damper on the recovery of consumption.

Facility investment showed a meek recovery due to continued regulation over corporate investment, such as prohibiting conglomerates from holding significant stakes in other companies, reinforcing the effect of the slowdown in the domestic consumption market. Construction investment remained stagnant due to the greatly shrunken private construction sector caused by the

Government's hard-line policy against real estate speculations. The slowdown in the domestic consumption led to the stagnation of the job market, making the problem of unemployment for youths more serious. In the second half of the year, in particular, there was a widespread fear of stagflation due to the jump in the price of raw material prices, including oil prices, despite of the low growth rate.

Second, looking at the nation's foreign trade, exports posted a high growth rate in 2006. However, the surplus decreased considerably, due to the rapid growth of imports and the deficit in service account. The problem further worsened because the exports recorded an extreme unbalance, by types of industries and regions. The growth of the import of capital goods remained low amid the slowdown of facility investment, whereas the import of raw materials increased considerably due to the rise in the raw material prices. Entire imports marked an annual growth of approximately 20 percent. Appreciation of Won against major currencies led to an increase in the deficit in service account, such as travel account, due to the drastic increase of the number of outbound travelers. Thus, the current account surplus posted a great year-on-year decrease.

Third, the instability of the financial market was heightened. In the foreign exchange market, the Won gained strength against the U.S. Dollar to a great extent in line with the U.S. currency's worldwide weakness despite of the drastic decrease in the nation's current account surplus. In the stock market, foreign investors' net selling caused frequent fluctuations in stock prices, although overall stock prices maintained an upward trend throughout the year on the back of the increase in the demand for local indirect investment funds.

Fourth, the nation remained caught in the trap of low growth from the viewpoint of growth and allocation. Trading conditions worsened as a whole in spite of the briskness of exports. The situation caused a sharp drop in the purchasing power of business and households. The size of investments has stood virtually still over the past decade following the financial crisis, doing great damage to the nation's growth potential. As a result, the nation's economy has recorded an economic growth rate lower than the average growth rate of the world over the past four years. To make things worse, the middle class has collapsed amid income bipolarization. In 2006, the nation's economic recovery lost steam again after only a year due to the external shocks, such as the jump in international oil prices and deepening geopolitical risks, on top of weakened vitality of the economy.

○ Even more unfavorable economic conditions expected in 2007

In 2007, the economic recession affecting the nation is expected to worsen further due to both internal and external problems. Economists are predicting global recession in 2007. In the second half of 2006, the U.S. economy started showing a sharp drop in the growth rate accompanied by a slowdown in the consumption sector following the cool-off of the housing sector. Such a downturn is expected to continue for some time to come. The EU and Japan appear to be getting out of the dark shadow of long-term recession; yet, their recovery does not appear powerful enough to drive the growth of the world economy. As for China, the belt-tightening policy is expected to become stronger and thus the growth will inevitably slow down.

Conditions for the nation's foreign trade will further deteriorate. The trend for an increase in world trade will weaken amid a drop in demand for goods made in developing countries due to the recession in more industrialized countries, including the U.S. And the Dollar is expected to remain weak against major currencies in 2007, due to the continued increase in the current account deficit, the slowdown of the U.S. economy, and the narrowing gap in interest rates in the U.S., Japan and Europe. In addition, it is highly likely that oil prices, which started showing a drop in the second half of 2006, may rebound due to the geopolitical instability in the Middle East and OPEC's decision to cut production. The slowdown of the world economic growth is likely to deepen trade frictions between industrialized countries and developing countries.

Price instability recently observed in China following the rise in wages and raw material prices are stirring the concern that inflation may start from China and spread to the rest of the world. The rise in the price of goods exported from China will stimulate the price of Chinese-made goods in major importing countries, such as the U.S. and Japan, thus possibly triggering the worldwide inflation.

Internally, experts are carefully watching out for the possibility of an increase in foreign exchange risks caused by volatility of the value of the local currency. It is expected that the local currency will gain more strength against the U.S. Dollar in 2007 due to the latter's weakness against all major currencies. Nevertheless, it is likely that the sluggish domestic economy coupled with heightening geopolitical risks associated with the situation in the Korean Peninsula will send mixed signal to cause the exchange rates

fluctuation. Worrisome voices about the possibility of economic sentiment worsening in connection with North Korea's nuclear program are being raised as well. It appears that the crisis situation triggered by the nuclear test from the year 2006 is giving way to dialogues and negotiations, with North Korea's consent to return to the Six-Party Talks and the Democrats' victory in the mid-term election in the U.S. However, unstable situation is expected to prevail in the Korean Peninsula in 2007, as it is not likely that the U.S. and North Korea will be able to bridge the gap in their views concerning the issue in hand at ease.

Finally, it is feared that in 2007 the direction of economic policies can be affected by political considerations with the upcoming Presidential election, thus adding to the uncertainty of the economy. Consistency or efficiency in policy cannot be expected if the economic policy hitches a ride on popularity. Reckless pump-priming measures, in particular, will add to the financial burden of the Government. Then, the Government will be forced to increase taxes or issue bonds, thus causing the crowding out effect and the shrinkage of the private sector share of the economy.

○ Economy expected to experience difficulties in escaping the low-growth trap

Under the influence of both internal and external factors on the national economy, the financial market will remain even more volatile amid the continued recession both in and out of the country in 2007. Business situation will vary greatly from sector to sector. First, the inter-Korean economic cooperation will take a step backward. The rate of economic growth is expected to roam around 4.2 percent, compared to 5 percent in 2006, because

of the sluggish domestic consumption and exports. By sector, the private sector consumption growth will post a slowdown from the year 2006 due to a decrease in real household income and an increase in household debts. Facility investment will be negatively affected by a variety of unfavorable factors, such as the insufficient improvement in investment-related measures, including the one that prohibits conglomerates from holding significant stakes in other companies and the regulation over the size of areas set for factories in the Greater Seoul area, recession both in domestic consumption and exports, and political/social unease. Construction investment will also remain weak due to the less-than-optimal situation in the real estate sector, despite the increase of investment in corporate cities and innovation cities in the public sector.

Under such circumstances, the job market will remain very sluggish in 2007. The rate of growth of those employed in the manufacturing sector will continue to drop. The power of job creation of the service sector, which has supported the job market, will also weaken. If oil prices and service charges rise despite domestic recession, commodity prices will be forced to rise as well. Current account is likely to post a deficit for the first time in the post-financial crisis period due to the slowdown of exports, the increase in the crude oil imports, and the rise in the service account deficit. The financial market will be affected much more by prevalent supply-demand situations in individual markets than by the poor performance of the economy as a whole. As for the stock market, stock prices can be expected to rise on the back of favorable factors, such as a drop in interest rates and the increase in the demand for installment-type investment funds. The Won will remain strong amid the Dollar's weakness against major currencies. However, there is no ruling out of the possibility that

the Won may sharply lose the value, if the domestic recession aggravates and geopolitical risks increase in the Korean Peninsula. Domestic interest rates are expected to decline modestly from 2006 under the impact of the local recession and low interest rates in major countries, including the U.S.

As for prospects of the business situation for industries in 2007, it is expected that semiconductor and shipbuilding sector will continue to enjoy brisk business. In 2006, the world's semiconductor business, except for Koreans, experienced disruption in production due to a delay in the transition to a new production process, which will exert an upward pressure on the unit price. In 2007, the sector will continue to enjoy business betterment as in 2006 in connection with Microsoft's launch of a new Window operation system, Vista, which will lead to an increase in production of PCs. The shipbuilding industry is also expected to prosper, as the business have already secured a backlog of existing orders worthy of more than four years.

Turning to the automobile, information technology, machinery, logistics and maritime sector, they will maintain a business situation similar to that of the preceding year. The automobile sector will post only a modest increase in production due to a decline in the U.S. economy and the sluggishness in the domestic market caused by high oil price. The information technology sector is expected to see bipolarization among business types. Wireless communication equipment business will enjoy further growth on the back of the expansion of the market for new services, such as terrestrial wave Digital Multimedia Broadcasting(DMB) and Wireless Broadband Internet. In contrast, most of the information technology business will post only a modest growth under the impact of the slowdown in the U.S. economy. Machinery business, which

enjoyed a favorable business situation in 2006 following a few years of recession, will face more difficult times due to the worldwide slowdown and the sluggish facility investment at home. Maritime business can expect to enjoy the China effect, as the Chinese economy is expected to post a high growth rate. But they will not be able to see conspicuously good year because of the ever-fiercer competition within the industry.

Construction business will continue to stagger amid the cool-off of the private real estate market caused by the Government's stringent policy against real estate speculation, despite positive factors in the public sector, such as the expansion of rental apartment and BTL(Build Transfer Lease) projects. The inter-Korean economic cooperation is expected to shrink for some time to come due to the political uneasiness in the Peninsula following the North's nuclear test. However, private trades and economic cooperation projects between the two Koreas will continue to grow, unless there are military conflicts between the U.S. and North Korea. The economic cooperation may slow down if the U.S. pressures South Korea into enhancing the transparency of the economic cooperation with the North and readjusting the speed or if people in the South raise strong objection to the provision of support to the North in connection with its nuclear program.

○ Five major issues of the domestic economy and countermeasures

In 2007, it is expected that matters, such as continued low growth, growing household debts, uneasiness in the foreign exchange market, current account deficit, fear of burst of the real estate bubble, shrunken economic psychology associated with the political uneasiness, and prevalence of populism associated

with the Presidential election, will emerge as major issues in connection with domestic economic conditions and prospects.

Experts express concerns about the possible economic crisis caused by snowballing household debts(reached 560 trillion won at the end of 2006) as the nation continues to post low growth. If the Government sticks to the financial belt-tightening policy to stabilize real estate price and raises interest rate, and if households' real income does not increase due to the economic recession, it is highly likely that many households will go bankrupt and financial institutions will experience managerial problems. Policy priority should be placed on increasing GNI(Gross National Income), which is closely associated with the market situation, and GDP, to minimize the possibility of such an economic crisis. The domestic economy should be revitalized through the promotion of interest rate/financial policies in a way conducive to brisk business activities, invigoration of corporate investment, and soft landing for construction sector to enhance GNI. It is also necessary to reinforce the close monitoring of household debts and consider mitigating the eligibility requirements in the credit resuscitation system. At the same time, the virtuous cycle structure for funds should be established by taking measures to move unproductive funds crowded in the real estate market to the stock market.

If the unease in the foreign exchange market worsens and the local currency drops sharply, the current account deficit could rise to limit the growth potential of the economy. The Government should enhance its ability to control the foreign exchange market to prevent volatility in foreign exchange rates. It is also important to keep monitoring the in/outflow of foreign currencies to block the possibility of stampede of domestic and foreign capital out of the

country in case of a political or military emergency. Measures should also be taken to cope with export barriers and mitigate the problem of current account deficit. Successful conclusion of the FTA with the U.S. will also be helpful.

In 2007, the real estate market will continue to put a damper on operation of domestic economic policies. Policies designed to stabilize real estate price should be taken in consideration of the fact that Koreans regard real estate as a target of investment for their old age and major factor in determining the educational environment for their children is an important. This means that real estate policy should be taken from a comprehensive and long-term perspective, in regards to supply-demand conditions for house type and expected changes in the demographics, instead of making attempts to stabilize real estate price on a short-term basis.

North Korea's nuclear program is likely to continue to pose a threat to the local economy. The Government should work towards enhancing its crisis management ability in preparation of a situation caused by a change in the attitude of either the North or the U.S. and reinforce mutually collaborative relations with allies, including the U.S., and the UN. It should also improve the efficiency of the economic crisis system and supplement the existing economic crisis early warning system and the financial risk management system that oversees uncertainties over factors affecting the nation's economy, including the North's nuclear program, fluctuations in foreign exchange rates and a jump in oil price. In connection with the Presidential election scheduled for 2007, popularity-conscious policies may hamper the smooth flow of the domestic

economy. Extreme caution should be taken not to adopt economic policies solely based on politics. In fact, consistent economic policy should be pursued purely based on economic consideration. The economic policy-related functions of the Ministry of Finance and Economy should be performed in a way to prevent confusions in the course of formulation of policy by the ruling party and the Government concerning the domestic economy, regulations over corporate activities, and taxes.

The Government's business-related policies should be focused on the establishment of the market economy principles, including epoch-making innovation of investment-related systems, rather than on issues related to management rights by improving the governance structure, because popularity-conscious measures are likely to lead to anti-business sentiment, which in turn will discourage firms' investment. In promotion of economic policies, emphasis should be made on Total Solution Policy, which fully consider their impact on the overall economy.

○ **Establishment of foundation for advanced economy focusing on growth, free market, and reconciliation**

The current problem of the Korean economy being caught in a low-growth trap is fundamentally attributable to its inability to adapt to changes in external condition in the 21st century: the cold war is over, the free market principle putting emphasis on efficiency and competition is spreading fast as the universal economic ideology, and a knowledge-based society is rapidly formed. At present, the Korean society finds itself unable to adapt to changes

made in the outside world amid the confusion of values and confrontations between generations and people from different backgrounds, thus causing dilapidation of the political, economic and social systems, and a drop in productivity. At this juncture, priority should be placed on supplementation of new growth engines having the free market economy take root through maximization of available economic resources, and consolidation of national strength through reconciliation, if the nation is to escape the low-growth trap and join the ranks of more advanced countries.

In order to supplement the nation's new growth engines, growth strategies should be established in a way that enables sustainable allocation based on a non zero-sum method designed to enhance the overall wealth through stimulation of the entire society's growth vitality with mutual understanding and cooperation, rather than on a zero-sum method, which simply transfers wealth from one part of society to another without growth. In addition, efforts should also be made for development of promising sectors, including information technology sector, reinforcing the competitiveness of the service sector, establishment of the financially virtuous cycle through the sophistication of the capital market, diversification of export destinations, and active promotion of FTAs with major trading partners.

Innovative steps should be taken concerning regulations and the goal of a smaller government should be attained for the more sound establishment of the free market economy. Efforts should be made to put an end to confrontations between people with different ideologies and backgrounds. Ways should be found for mutual understanding and

reconciliation. Atmosphere should be fostered for cooperation between SMEs(Small & Medium-size Enterprises) and conglomerates, between those living in urban and rural areas. The Government should play a more active role to help settle conflicts among components of the society. Strong leadership is required to consolidate different public opinions and push ahead with policies seeking growth, free market and reconciliation. 2007 should be a year in which fruitful policy measures are taken under strong leadership.

Political and social systems should be innovated to attain the goal of enhancing the national economy to another level. Legalism should be established, election system and political culture should be innovated in accordance with global standards, and free market economy should be established, in addition to efforts for reconciliation and trust between components of the society. As a prerequisite for sophistication of the economy, innovations should be made in education in a way that befits the knowledge-based era, along with those in politics and economy and social affairs. In educational innovation, emphasis should be made on creativity and intellectual ability while stopping the uniform equalitarianism and continuing the innovation in education and training.

Finally, new values suited to the new era should be established. Humanistic capitalism should be established to put an emphasis on the importance of free market principle and human dignity. Creative and challenging spirit should be encouraged, and dynamic mind set of reconciliation should be fostered among the people.

I. Korean economy faced with transitional crisis

The nation's economy appears to have had difficulties in regaining the vitality. In 2006, the economy posted an anemic growth (about 1 percent), despite a growth close to 5 percent in GDP, showing a deepening gap between leading economic indicators and market-sensed economic situation. It has recorded an economic growth rate lower than the average growth rate of the world over the past four years. The stagnation of real national income and the low growth leads to slowdown in consumption and investment as well as an unstable employment situation. It is also likely to cause a drop in growth potential in a vicious circle of poverty.

Drop in productivity due to dilapidation of social system

The current problem of the Korean economy being caught in a low-growth trap is fundamentally attributable to its inability to adapt to changes in external condition in the 21st century. The world is changing rapidly in a future-oriented, knowledge-based society amid the wave of globalization and trend of greater emphasis on intellectual ability and creativity of people. The cold war ended toward the end of the 20th Century. Digital technology has become the talk of the town. The free market principle that puts an emphasis on efficiency and competition is taking root all over the world as a universal economic concept. A knowledge-based society is being rapidly formed in which the intellectual ability and creativity of people becomes a core factor of competition.

In contrast, Koreans are still engaged in anachronistic ideological discourses or uniform equalitarianism. At present, backward rural villages, industrial complexes, and the information technology sector coexist in the nation as a result of condensed growth that led to confusion of values and confrontations between generations and people from different backgrounds. In short, it can be said that the nation's economy is experiencing transitional hardships.

In his book *Revolutionary Wealth*, Alvin Toffler stresses that the phenomenon of "crash of speed" occurs when all sectors of a country or a society fail to adapt to changes in external world in a timely manner and some sectors taking a longer time than others in making adjustment to pose a stumbling block for the nation's development. This shows that synchronization is a prerequisite to a high level of growth and development in political, economic, social, cultural, and educational sectors. The fundamental cause of a recent drop in Total Factor Productivity (TFP), which is indicative of the level of advancement of the national system contributing to the economic growth, besides investment and labor, can also be found here. Only when other related sectors, such as political, social, and cultural, go in alignment with the economic sector, can the entire system operate efficiently.

In such a context, it can be said that J. Liebig's Law of Minimum, which states that a plant's development is limited by the one essential mineral that is in relatively short supply, visualized as "Liebig's barrel," applies to the national system. A plant cannot grow properly if it lacks any one of essential nutrients (such as nitrogen, phosphate, and potassium) even if others are supplied in abundant quantities. Likewise, the overall level of a system is determined by one with the lowest level among components. If the level of the political sector

of a country is lower than other sectors, the overall system of that country cannot advance beyond the level the political sector.

Foundation for advanced economy established through growth, free market, and reconciliation

After all, the fundamental problem of the nation's economy can be found in a drop in productivity caused by the dilapidated political, economic, and social system, which is unable to cope with changes made in the outside world. Under such circumstances, the nation must focus on the pursuit of the economic growth strategy and the free market principle, national reconciliation, and recovery of leadership if it is to regain the vitality for economic growth and join the ranks of more advanced countries, overcoming the low-growth trap and the transitional confusion.

First of all, top priority should be placed on the establishment of a growth strategy that will help the nation escape the low-growth trap in promotion of economic policy. All the government efforts should target the establishment of the structure for virtuous circle of growth through the invigoration of corporate investment and creation of jobs, which will lead to an increase in income and consumption and then to growth. It is important to push ahead with the innovative growth strategy based on new technologies instead of simply increasing the investment.

Then, the foundation of free market economy should be expanded. When the free market economy based on free activities and competition takes root, resources can be rationally allocated to enhance the efficiency so that the

growth potential may be maximized. The Government should make up for the dysfunction of the market through supplementation of the social safety network designed to protect the economically vulnerable. Efforts should be made for social stability and national reconciliation to prevent the waste of national strength caused by conflicts and confrontations. Social integration can be solidly carried out when members of the society build trust in each other in good faith. Establishment of law-abiding attitude is a prerequisite to the strengthening of trust between members of the society and the realization of social integration.

Continued innovation should be made in the education and training system, focusing on enhancement of participants' creativity and intellectual ability. Betterment of the social systems and their efficiency depends on the success in education and training. In the new era, educational innovation should be carried out in a way that can cope with changes made in the outside world, putting an emphasis on the intellectual ability of people and creativity. Efficiency of social systems cannot be enhanced without education that stresses creation of new values and respects diversity and uniqueness. In the era of limitless competition, the nation will fall behind others if it sticks to the current method of education that focuses only on earning an entry into prestigious universities, when other countries have already started taking steps for education stressing the importance of creativity and diversity.

Korea needs a strong leadership that can help it overcome the transitional confusion and make further progress to join the ranks of more advanced countries through reconciliation and collaboration with a shared vision.

II. Deepening gap between major economic indicators and market-sensed economic situation – Key characteristics of the Korean economy in 2006

In 2006, the Korean economy posted a relatively high growth at about 5 percent. However, the gap between major economic indicators and market-sensed economic situation has deepened amid the anemic growth of GNI(Gross National Income), with the market situation contradicting positive economic indicators.

The economy showed a downturn in the second half of the year due to the weakened recovery of consumption and facility investment, with construction investment showing continued slowdown. Such a situation weakened the job market. In the second half of the year, commodity price became volatile due to a sharp rise in oil price and other factors, despite the low growth rate, making experts concerned about the possibility of stagflation. The nation's exports remained brisk on the back of the increase in the volume of worldwide trades amid a high growth of the world economy. However, current account surplus showed a drastic decrease due to a sharp increase in the raw material imports caused by high international oil price and an increase in the number of outbound travelers encouraged by the appreciating local currency.

Despite the domestic recession, the local financial market remained solid, showing that it moved not in alignment with the overall situation of the economy. The local currency sharply appreciated as the U.S. Dollar grew weak against all major currencies even though the nation's current account surplus

increased. The nation's capital account surplus much higher than that of Japan resulted in the Won gaining strength, bringing the Won-Yen exchange rate to 700 won against 100 yen. The Won held a greater strength against the U.S. Dollar than against the Japanese yen. The KOSPI(Korea composite stock price index) made a break beyond the 1,400-level at a record high, on the back of the improvement in the supply-demand situation with the increase in the demand for indirect funds, despite of the continued outflow of foreigners' stock investment funds and the uncertainty over the domestic economy. In the bond market, long-term interest rates dropped because of the uncertainty over the domestic economy. The gap between long-term and short-term interest rates was reduced due to the rise in short-term interest rates following the rise in the Government-set benchmark rates.

Overall, in 2006, the domestic economy was characterized by a slowdown in GNI, a conspicuous rise in commodity price, a decrease in profit from foreign trades, and higher instability in the financial market, showing another year of a low growth.

Slowdown in GNI and rise in commodity prices

In 2006, the economy posted a growth rate higher than that of the preceding year. However, GNI remained stagnant and commodity prices showed a conspicuous rise, putting a damper on the economic vitality in the private sector.

Slowdown in consumption : First of all, the recovery in consumption, which accounts for about half of GDP, slowed down. The growth rate of private

consumption in the national account posted 4.8 percent year-on-year in the first quarter, compared to 3.2 percent for the entire year of 2005. However, it started to drop sharply in the ensuing period to 4.0 percent in the third quarter. The fact that the recovery in consumption lost steam after only a year is attributable to the inability of households to build positive strength for consumption. Earned income of the middle-class people with high propensity for consumption and the low-income people stayed stagnant, as economic vitality and ability for job creation weakened following years of low growth. Conditions for trades worsened due to the rise in price for imported goods following the rise in international oil price, and the purchasing power of households dropped. The sharp rise in household debts also served as a reason for a drastic drop in consumption. At the end of the third quarter of 2006, the total balance of household credit stood at 558.8 trillion won, to mark a 7.2 percent increase from the end of the preceding year, or a two-fold increase from 266 trillion won at the beginning of 2001. It is judged that the burden of interest payment for such debts and their repayment aggravated the consumption situation. Elsewhere, the impact of an increase in asset income on the entire consumption fell short of expectations due to the shrinkage of real estate transactions after the implementation of the Government's stringent policy against real estate speculations.

Anemic facility investment : In the first three quarters of 2006, the growth rate of domestic facility investment stood at about 8 percent, compared to about 5 percent for the entire year of 2005. However, such a growth was not sufficient as a stimulus for the domestic economy. It is thought that an annual growth rate of facility investment lower than 10 percent did not warrant

large-scale expansion of existing facilities, with real facility investment made over the past decade following the financial crisis standing still. The anemic facility investment in 2006 can find its reason in the shrinkage of investment due to the recession in the domestic market, the local currency's strength and the rise in raw material price. The weakened investment psychology of business amid the uncertainty over the economic situation in the second half of the year also served as a reason for the anemic facility investment. Other dampening factors include the regulations prohibiting conglomerates from holding significant stakes in other companies and limiting the construction of factories in the Greater Seoul area.

Stagnant construction investment : In the first three quarters of 2006, construction investment posted a year-on-year decrease of approximately 1 percent. The stagnant investment is attributable to the shock experienced by the private construction sector following the implementation of the Government's stringent policy against real estate speculations. In the second half of 2006, the Government started making attempts to stimulate the construction business by setting up plans for investment in construction of the Multifunctional Administrative City and corporate cities. However, the fundamental problem in such plans was the adoption of the BTL (Build Transfer Lease) method¹⁾, for which private firms should bear a considerable part of necessary expenses. Private senior did not show as much enthusiasm in the projects as the Government had anticipated. Thus, the plans in investment in the public sector

1) Under the BTL (Build-Transfer-Lease) method of investment, private firms build public facilities, using their fund, and are allowed to hold the ownership of the completed facilities for a given period of time to recover the facility investment they put by leasing them to the government.

did not go a long way toward making up for the stagnation in the private construction sector.

Slump in employment : The sluggishness of the domestic economy led to a slump in the job market in 2006. Although the unemployment index stood at close to 3percent, an improvement from 3.7 percent in 2005, the job market found itself in a worsening situation from a structural viewpoint. In October 2006, the number of unemployed youths, i.e. those aged 15 through 29, stood at 364,000, accounting for 46.1 percent of the total number of the unemployed (789,000). The percentage of the unemployed youths rose sharply to 8.0 percent from 7.2 percent a month before. Despite a close-to 1 percentage point increase in the economic growth rate from 2005, job opportunities did not show a considerable increase amid the slowdown of domestic consumption. The number of people who have given up seeking jobs, who are not included in the unemployment survey, is estimated to be about 120,000.

Rise in commodity price : In the second half of 2006, commodity price became volatile due to a sharp rise in the price of imported goods amid a jump in oil price, despite the low growth rate, spreading the fear about the possibility of stagflation. In the first ten months, the domestic consumer price remained stable, showing an about 2.5 percent year-on-year rise. Core inflation, a benchmark price index for the Bank of Korea's monetary policy, remained at about 2 percent, compared to the 2.5 ~ 3.5 percent range set as a target for stabilization of commodity price. However, time-lag effect associated with a sharp rise in international oil price put an upward pressure on domestic commodity price. Household-sensed commodity price recorded a rise close to 3

percent, much higher than consumer price index or core inflation index, indicating a stagflation-like situation, with commodity price remaining high in a low-growth period.

Decrease in surplus from foreign trades

In 2006, the nation posted a high percentage of growth in imports and service account deficits, resulting in a drastic decrease in surplus from foreign trades.

Worsening export structure : The nation continued to enjoy brisk exports, despite of the sluggishness in the domestic economy. From January to November of 2006, exports recorded higher than 14 percent in growth, compared to 12 percent in 2005, on the back of an increase in overall trade volume and a high rate of economic growth throughout the world. According to IMF(International Monetary Fund), the rate of growth in worldwide trades came to 8.9percent in 2006, compared to 7.4 percent in 2005.

However, exports showed two extremes by business type. Taking semiconductor business, for example, they posted close-to 20 percent in export growth rate, compared to 13 percent in the preceding year. Car exports also recorded a close-to 10 percent growth rate year-on-year. Exports of petrochemical goods followed the suit, posting a close-to 14 percent growth. On the other hand, there were sectors that did poorly in 2006. Light industry exports showed a declining streak in 2006 as in the preceding year. The exports of LCDs(Liquid Crystal Displays) and computers, recorded a close-to 10

percent decrease from the preceding year due to the continued worldwide supply glut.

The nation's exports also showed an uneven situation, depending on their destinations. Exports to China, the nation's No.1 export destination, showed a steady growth with the rate of higher than 10 percent in 2006, after a growth rate as high as 24 percent in the preceding year. Exports to the E.U. and Japan recorded a 15 percent and 10 percent year-on-year growth, respectively. In contrast, exports to the U.S. showed a growth rate of about 5 percent, a low percentage compared to other major export destinations, though they made a positive turnaround from negative growth in 2005.

Drastic increase in amount of raw material imports : In 2006, the growth rate of imports stood at about 20 percent, compared to 16.4 percent in 2005. The relatively high growth rate for imports amid recession in the domestic economy is attributable to a jump in international oil price. The unit price for crude oil imported by Korea rose from about \$50 in 2005 to about \$70 per bbl in September 2006, with the quantity of crude oil import showing no big difference between the two years. Thus, the share of crude oil in the nation's entire imports rose from about 16 percent in 2005 to 18 percent in 2006. Imports of consumables also recorded a high growth rate of close to 30 percent. This is chiefly attributable to the rise in purchasing power on the back of the local currency's strength and the increase in high-ticket items. In contrast, the growth rate of capital goods imports remained at about 10 percent, a level similar to that of the preceding year under the impact of the slowdown of domestic facility investment.

Drastic decrease in current account surplus : In 2006, current account surplus dropped sharply from \$16.6 billion in 2005 to \$1.7 billion in 2006 (as of October) due to a decrease in trade surplus caused by a sharp rise in imports and an increase in service deficit owing to the local currency's appreciation. Service deficit, in particular, stood at \$15.5 billion in the January ~ October period, compared to \$13.1 billion in 2005, mainly due to a drastic increase in travel account deficit. On the other hand, capital account recorded a surplus of \$13 billion, following a sharp increase in banks' borrowing in foreign currencies, despite of the net outflow of foreigners' stock investment funds (12.3 trillion won in the January ~ November period). Such an unbalance in the nation's international accounts caused the local currency to remain strong against key currencies, such as U.S. dollar or Japanese yen, failing to reflect the domestic economic situation.

Greater instability in financial market

In 2006, the domestic financial market remained solid, despite the recession of the domestic economy, showing discrepancy from the market-sensed economic situation.

Won's sharp appreciation : Despite the drastic decrease in the nation's current account surplus, the local currency gained strength sharply against the U.S. Dollar as the latter exhibited weakness throughout the world. At the beginning of 2006, the Dollar traded at 1,008 won, but continued to drop in its value and traded at 900 won, the lowest level in the post-financial crisis period, towards the year-end. The Won's strength against the Dollar was due to a sharp surplus of dollar liquidity in the domestic foreign exchange market as well as the

latter's weakness against virtually all major currencies. The Dollar remained weak against major currencies because of the continued current account deficit of the U.S. and concerns about downturn of the U.S. economy. Thus, the Won gained against the U.S. currency. The Won gained further against the Dollar because of a sharp increase in domestic banks' borrowing in foreign currencies and exporters' selling of futures as a means of hedging against exchange risks, which resulted in ample dollar liquidity in the domestic foreign exchange market, despite of the outflow of foreigners' stock investment funds.

With domestic capital account recording huge surplus, the Won gained strength against the Yen to the point of 700 won/100 yen. The Won gained greater strength against Dollar than against the Japanese yen. At the beginning of 2006, the won-yen exchange rate stood at 860 won against 100 yen. In the second half of the year, the Won continued to gain strength to the point of 700 won/100 yen, at a record-high value for the post-1997 period. The Won's sharp appreciation against the Yen can be attributed to the difference in the supply-demand situation in the foreign exchange markets in Korea and Japan. Due to the increase in yen-carry funds coming out of Japan to look for higher interest rates, its current account surplus was offset by its capital account deficit. Thus, the Yen remained modestly weak against the U.S. Dollar, despite of the latter's weakness against major currencies. In contrast, Korea observed a continued capital account surplus amid the increase in local banks' demand for the Dollar and in short-term foreign debts.

Long-term adjustment in stock market : In 2006, KOSPI(Korea Composite Stock Price Index) made a breakthrough the 1,400-level, a record figure, on the

back of the improvement in the supply-demand situation with the increase in the demand for indirect funds even though the outflow of foreigners' stock investment funds and the uncertainty over the domestic economy continued. Early in the year, the stock market showed bullishness on the back of widespread expectations about economic recovery. However, the period of adjustment followed due to foreigners' continued net selling and the worsening of economic indicators in the second half of the year. In the January ~ November period of 2006, foreign investors sold stocks worth a net 2 trillion won, particularly of blue chip and electronic/electric industry, bringing their share in the total market value to 37 percent, compared to higher than 40 percent as the end of 2005.

Reduction of gap between short-term and long-term interest rate : In 2006, long-term bond rate dropped under the impact of the uncertainty over the domestic economy. Short-term rate rose due to a rise in the Government-set benchmark rate, thus causing the difference between long-term and short-term interest rate to be reduced. 91-day CD short-term rate rose from 4.1percent at the end of 2005 to close to 4.5 percent in the second half of the year. In contrast, treasury bond long-term (3 year) bond rate dropped from 5.1 percent to about 4.5 percent. Thus, the difference between long-term and short-term interest rate was reduced to less than 0.1 percentage point from 1 percentage point early in the year. It is judged that the Bank of Korea's raising call rate, which was intended to mitigate the inflationary pressure, had the most conspicuous impact on the rise in short-term interest rate. The drop in long-term bond interest rate is attributable to the preference for low-risk assets particularly on the part of institutional investors because of the spreading concern about the slowdown of the economy.

Inability to get out of low-growth trap

Structural problems of the nation's economy, which affected the market situation in 2006 as in preceding years, are as follows: a sharp drop in purchasing power following worsening trade conditions, a drop in the growth potential, deepening bipolarization of income, collapse of the middle-class, continued gap between the domestic economy and the world economy, and shortening of business cycle. Trade conditions worsened despite the briskness of exports, thus causing a sharp drop in the purchasing power of households and business. Growth potential has weakened considerably as a result of anemic corporate investment over the past decade following the financial crisis. Thus, the economy finds itself unable to get out the low-growth trap, not reaching the world's average economic growth rate for four straight years, the first of its kind the country has experienced in its history. Worse, with the collapse of the middle class, income bipolarization deepened. The Government has adopted various welfare measures to solve the problem through wealth redistribution. However, such a policy has not come a long way as it was not supported by growth. Uncertainty over the economy prevailed under the impact of shocks from external factors, such run-ups as of oil price, the local currency's appreciation and deepening geopolitical risk, on top of a structural problem related to growth and distribution. Moreover, the domestic economic cycle has appeared to be shortened noticeably in the post-foreign exchange crisis period.

Worsening trade conditions : Trade conditions worsened considerably under the impact of a drop in export unit price and a rise in import unit price, despite the briskness of exports. Net barter terms of trade, which refers to the quantity of goods that can be imported with exports, fell considerably from 100 in 2000 to 71.2 in the third quarter of 2006. The worsening trade conditions reduced real profit from trade, with real loss trade increasing sharply from 13.8 trillion won in the fourth quarter of 2005 to 17.9 trillion won in the third quarter of 2006. This phenomenon can stem from a sharp rise in import prices caused by high international oil price. The country exported goods did not exert sufficient market dominance and thus their unit price could not catch up with the rise in import price. This also contributed to the worsening of trade conditions. Consequently, people's real purchasing power weakened, causing the recession in domestic consumption to continue. As a result, GNI²⁾, which is an indicator of the purchasing power of those engaged in economic activities and market-sensed economy, remained at the paltry level of close to 1 percent in its growth rate, compared to about 4.5 percent for GDP.

Collapse of the middle class and income bipolarization : The continued recession has put a damper on the economy's ability for job creation and caused the collapse of the middle class, which makes it

2) GDP is the measure of the outward size of the economy focused on production, while GNI is an indicator of people's real purchasing power evaluated with profit from foreign trades considered.

difficult for the country to get out of the low-growth trap. The number of applications for individual bankruptcy submitted to the court, which is an indirect evidence for the collapse of the middle class, increased sharply to about 100,000 in 2006, compared to less than 10,000 in 2003. The collapse of the middle class further deepened income bipolarization. The gap between the people of the highest and the lowest income³⁾, appears to stand at 7.79 in the third quarter of 2006, the highest level since the survey was first made in 2003.

Drop in growth potential : Problem facing the Korean economy is that it will not be able to escape the low-growth trap unless a drastically remedial measure is taken. That is because the economy has been afflicted with continued sluggishness in investment, which blocks accumulation of capital as a growth engine. The amount of real domestic facility investment in the post-financial crisis period has remained at the level close to that in 1996, right before the financial crisis. When construction investment is included, the growth rate of total fixed investment dropped to close to 2 percent in the post-2003 period. The anemic investment led to a drop in growth potential from about 6 percent in the 1990s to about 4.5 percent in the 2001 ~ 2004 period and to about 4 percent in the period following 2005.

3) The "The gap between the people of the highest and the lowest income" refers to mean income of people in the highest income bracket (one-fifth of the entire population) divided by mean income of people in the lowest income bracket (one-fifth of the entire population). Along with Gini's coefficient, it is regarded as a leading indicator for income distribution among the population.

Continued gap between domestic economy and world economy :

The weakened growth potential led to an extended low growth of the economy. The growth rate of the economy continued to remain below that of the world economy (including that of East Asian countries in the economic development stage similar to that of Korea) in the 2003 ~ 2006 period. The nation must take measures to boost growth higher than the mean growth rate of the world for years to come, as it has not yet gotten out of the status as a developing country.

Shortened business cycle : Finally, it should be pointed out that the country domestic economic cycle has sharply shortened since the post-1990s: to 12 months in the years following 2003 from an average of 34 months during the rising period in the pre-financial crisis years. The shortened span for the rising period is attributable to higher uncertainty over the economy due to the hike in oil price, the local currency's appreciation and geopolitical risks as well as the weakened growth potential of the economy. It should be noted that such fluctuations in the direction of a nation's economy increases uncertainty over future prospects for those engaged in economic activities and give adverse impact on investment and consumption. In the past few years, the consumer sentiment index(CSI) showed a pattern of rise early in the year and drop at year-end. The business survey index(BSI) has shown frequent fluctuations in the directions as well. All these are judged to show unease felt by those engaged in economic activities.

III. Changes in economic conditions causing fear of undesirable internal and external factors – Prospects of conditions in 2007

In 2007, the nation's economy is expected to face various difficulties caused by both external and internal factors. External factors affecting the economy will include the slowdown of the world economy, worsening of trade conditions and fear of inflation that may be triggered in China and spread worldwide, and internal factors include higher exchange risks associated with fluctuations of the value of the local currency, an increase in current account deficit, shrunken economic psychology associated with geopolitical risks, including North Korea's nuclear program and unstable political economic situation associated with the Presidential election.

(External conditions)

Global Recession

In 2005, most of the major countries showed economic recovery or briskness, which could be summarized as global expansion. In the second half of 2006, the U.S. economy showed a sharp drop in its growth rate, whereas the E.U. and Japan recorded a continued recovery, displaying a situation of decoupling.

In the third quarter of 2006, the U.S. economy abruptly slowed down, posting a 1.6 percent growth, after showing a very robust growth (5.6 percent quarter-on-quarter growth) in the first quarter. As for the E.U., it posted a

growth rate of about 1 percent, a similar level to that of the preceding year, on the back of the solid growth of the French economy and the briskness of industrial production in Germany. Japan also posted a solid growth rate of higher than 2 percent on the back of the recovery in consumption and corporate investment. China, which has emerged as a leading growth engine of the world economy along with the U.S., continued to post a solid growth of higher than 10 percent on the back of briskness of exports and investment in fixed assets.

In 2007, global recession is expected, with the U.S. economy continuing to slow down and the economy of China, E.U., and Japan showing a decline. By country, the domestic consumption of the U.S., a core sector for growth, is expected to experience sluggishness. Such a forecast is based on a decline in the housing sector and a decrease in corporate investment, which was started in the second half of 2006. The E.U. countries are expected to see a drastic slow down in their economic growth (i.e. about 2 percent, compared to about 2.5 percent in 2006) from the first half of 2007, following the continued recovery until the second half of 2006. Most of the E.U. countries will see their budget deficit exceed the "3 percent of GDP" target set in the Stability and Growth Pact. The rise in the value of euro will inevitably cause a slowdown in exports. As for Japan, its economy will be on the course of recovering from a long drawn-out recession, but the growth rate will be lowered to approximately 2 percent in 2007 from higher than 2.5 percent in 2006, owing to a slowdown in exports to the U.S. due to the recession in the U.S. economy. There is no ruling out the possibility that the country's economic growth rate may drop to the some 1 percent-level, following the shrinkage of private consumption and corporate investment, which currently play a major role in driving the

economy, should the U.S. economy suffer a drastic slowdown and the Yen's value rise sharply. Turning to China, the government is expected to aggressively push ahead with a belt-tightening policy in such areas as real estate, interest rate and facility investment. Thus, the economy inevitably slowing down from the second half of 2006. National Development and Reform Committee of the country expects a single-digit growth in 2007.

Worsening trade environment

It is expected that the world trade volume will decrease, the dollar will remain weak and there will be fiercer trade frictions between countries amid a slowdown of the world economy, including the U.S. economy. International oil price started dropping in the second half of 2006, but they may rebound amid geopolitical unease in the Middle East.

Growth of world trade volume weakens : It is expected that the growth of the world trade volume will inevitably slow down due to the global recession. It is highly likely that exports from developing countries will stagnate due to a slowdown of imports on the part of most industrialized countries, which will experience a decline in their economies. According to IMF, the growth rate of imports by industrialized countries will drop from 7.5 percent in 2006 to 6.0 percent in 2007, while that of NIEs (Newly Industrialized Economies), including Korea, will drop from 8.9 percent to 7.9 percent in the same period.

U.S. Dollar remaining weak : In 2007, the U.S. Dollar is expected to remain weak due to various unfavorable factors, such as an increase in its

current account deficit, the slowdown in the economy, adoption of the policy for diversification of foreign currencies held on the part of countries possessing huge Dollar reserves, and the reduction of the difference in interest rates in the U.S. and Europe following the U.S. decision to stop the procession of interest rate hikes. By the end of 2006, the U.S. current account deficit will reach a record level of \$800 billion, raising the share of budget deficit in GDP to about 7 percent in 2007 from about 6.5 percent. The reduction of the difference in interest rates in the U.S. and those in other countries will also serve as a reason to weaken the U.S. currency. The FRB of the U.S. is expected to maintain the benchmark interest rates at a level similar to that of the previous year or raise them just modestly for fear of downturn of the economy, whereas market watchers say that the ECB (European Central Bank) will raise its benchmark rate up to about 4 percent in 2007 from 3.25 percent set in October 2006. Accordingly, international investment banks forecast that euro will gain against the U.S. dollar at least to a level of 1.3 dollars by the end of 2007 and that the dollar will trade at 106 yen, compared to an average of 116 yen at the end of 2006.

Rebound in international oil price : In the second half of 2006, international oil price settled at a relatively lower level amid a declining demand during summer and stabilization of the political situation in the Middle East, while speculative funds stayed away. However, it is doubtful whether oil prices will continue to remain at a low level in 2007. There will be a continued demand for oil on the part of developing countries, particularly from BRICs, and there is a possibility that the political situation in the Middle East or other oil producing countries like Nigeria, may get

worse at any time, although the demand for oil in industrialized countries will slow down amid the global recession. Furthermore, factors of unease, such as OPEC's decision of oil production cut, continue to exist in the market. It should also be noted that OPEC's capability to meet an increase in demand is very limited, as a result of its having reduced additional production capacity from up to 10 million bbls/day in the mid-1990s to about million bbls/day. It also took a step to reduce a million bbls from the daily maximum production capacity of 28 million bbls in October 2006, showing that they were more interested in maximization of its profit than in worldwide oil price stabilization. Occurrence of a factor of unease is likely to cause a rebound in international oil prices.

Increase in trade friction : In 2007, international trade condition will worsen due to the global recession. It is expected that the slowdown of the world economy will lead to an increase of trade friction between developing countries and industrialized countries, where the latter countries are the major importers of the goods produced in the former. Industrialized countries will impose more stringent environmental regulations over the use of hazardous materials and the emission of carbon dioxide or push ahead with measures associated with biodiversity or things like that. The E.U. has already imposed regulations over the import of household appliances contain heavy metals such as mercury and lead, while making it obligatory to use recycled materials for more than 80 percent of the parts of refrigerators and washing machines. Japan and the E.U. has taken a stand to regulate imports from countries neglecting to fulfill the obligation for reduction of greenhouse gas emissions as stipulated in the Kyoto Protocol to UNFCCC(UN Framework

Convention on Climate Change). Recently, many countries have provided for the procedure for transportation of genetically modified organisms(GMOs) and say that they will reject the import of goods lacking the proof of scientific stability. Elsewhere, Korea and the U.S. will have a hard time making negotiations over difference in opinion in the ongoing FTA negotiations.

Concerns about the probable global inflation triggered by China

In China, unstable situation will prevail over prices amid a rise in labor cost and raw material price. The situation will cause a rise in price for goods exported from China, stimulating prices in the U.S. and Japan and may spread inflationary pressure throughout the world. In the second half of 2006 and thereafter, Chinese-made goods are under the pressure for price hike due to a sharp rise in wage and raw material price or more stringent environmental regulations. The growth rate of wage, which stood at only 0.2 percent in 1998 skyrocketed to 18.2 percent in 2005. Domestic price for raw materials and energy sources in China also soared. On top of it, chinese manufacturers find it inevitable to raise their production cost under the government's imposition of more stringent environmental regulations. As a result, producer price soared by close-to 3 percent in 2006, compared to only about 1 percent. Andy Xie, an expert on the Chinese economy, says that the increase of price for exported goods by Chinese manufacturers based on the rise in their production cost will cause additional inflationary pressure of 0.5 percentage point to the U.S. and 0.7 percentage point worldwide.

(Internal conditions)**Increase in foreign exchange risk caused by volatility in Won's value**

In 2007, the Won's value against the U.S. Dollar is expected to fluctuate, depending on external and internal factors. The Won-Dollar exchange rate fluctuation band was already made larger from 60 won in 2005 to 80 won in 2006. In 2007, the Won will remain strong against the Dollar due to the weakness of the latter against major currencies. However, there is every possibility for fluctuations of exchange rates that can reverse the current situation due to the domestic recession or geopolitical risks surrounding Korea.

Under such circumstances, there is a possibility that the won-dollar exchange rates may fluctuate between 800 won and 1,000 won in 2007. The problem is that the domestic economy can be affected much more by volatility of exchange rates than by the direction of exchange rates. In the event of abrupt fluctuation in exchange rates, domestic firms will experience difficulty in production, supply of raw materials, and securing of funds and investment, and such a situation may aggravate the situation concerning both domestic consumption and exports.

Crisis caused by North Korea's nuke program and geopolitical risks

In 2007, the relation between the two Koreas is highly unlikely to improve amid the lengthy process of negotiations related to the North's

nuclear program and limitations in the Government's promotion of engagement policy in connection with the Presidential election. The crisis situation caused by the North's launch of missiles and nuclear test in 2006 is expected to become less serious with the North's consent to return to the Six-Party Talks on October 31, 2006, and the Democratic Party's landslide victory in the U.S. mid-term election. It is expected that the crisis situation related to the North's nuclear program focused on sanctions will change direction to the road of dialogues and negotiations, and there is a high possibility that the U.S. foreign policy based on unilateralism supported by military power may give way to constructive engagement stressing dialogues and compromises, following the mid-term election. However, the U.S. and North Korea are maintaining fundamentally different views about how to find a solution to the current situation. The U.S. is of the position that material compensation is possible only when the North confirms its intention of complete halt to its nuclear program, whereas the North says that it can scrap its nuclear program only when the U.S. withdraws its step taken to freeze the North's account at Banco Delta Asia, agrees to the normalization of relations with the North, and promises to resume the supply of heavy oil. Thus, the negotiation will take a lengthy and bothersome process before the concerning parties reach an agreement, while the framework for the Six-Party Talk remains unchanged.

The inter-Korean economic cooperation is expected to remain stagnant for some time to come due to the negative public opinion and limitations in the Government's promotion of engagement policy in connection with

the Presidential election. The Government is expected to maintain the existing relations with the North to prevent additionally adverse situation based on the principle of stable denuclearization of the Korean Peninsula and minimization of threats to the national security and economic activities, while observing the UN resolutions adopted concerning the North's nuclear test. However, it will not be easy for the Government to push ahead with its engagement policy toward the North as aggressively as in the past due to the difference in views taken by South Korea and the U.S. regarding the solution to the problem, negative public opinion in the South following the North's nuclear test and the powerful opposition party's resistance. However, there is also a possibility that the two Koreas may open a new page in their relations if the Government decides to dispatch a special emissary to the North to look for a favorable chance in connection with the Presidential election and if the North agrees to developing constructive bilateral relations to get out of the difficult situation involving the international community's joint steps for sanctions against it.

Political economic situation in connection with Presidential election

It is feared that in 2007, the directions of economic policy can be affected by political considerations in effect of the Presidential election, thus adding to the economic uncertainty.

Concerns about popularity-conscious policies : In connection with the Presidential election scheduled for 2007, it is feared that direction of

economic policies may be influenced by political economy. Economic policy should be kept consistent purely based on economic considerations. Economic policy-related functions of relevant ministries should be performed in a way to prevent confusions in the course of formulation of relevant policies, keeping in mind that adoption of reckless stimulus-packages, for example, can add to financial burden of the government and increase tax or issuance of government bonds, which may cause the crowding effect and shrink the vitality of the private economy.

Increase in financial burden to Government : Looking at expected financial conditions for the Government in 2007, it is expected that the amount of national debt will increase from the preceding year due to continued deficit in general account and issuance of foreign exchange stabilization bond. Annual revenue conditions will not improve due to continued low growth. In integrated current account balance⁴⁾, Government-controlled accounts balance will post a level of deficit similar to that of 2006, with the exception of social security-type funds and amounts required for repayment of public funds. Still, tax burden ratio will rise to about 21 percent due to an increase in the Government's welfare-related expenses and the decrease in the number of those eligible for tax reduction/exemption. Under such conditions, there will be a limit to what the Government can do to stimulate the economy with an increase in fiscal expenditure.

4) It refers to an accounting method of considering budgets belonging to general account, special account, and Government-controlled funds altogether.

IV. Domestic economy experiencing difficulties in escaping the low-growth trap – Forecast on the domestic economy in 2007

Current conditions both at home and abroad make it possible to forecast that in 2007 the nation's economy will get back into recession, with a slowdown in both the domestic consumption and exports, and volatility in the financial market will increase. There will be definite difference in briskness by industries and the economic cooperation between the two Koreas will take a backward step.

Slowdown in both domestic consumption and exports

In 2007, the nation's economic growth rate will stand at 4.2 percent, compared to about 5 percent in 2006, amid a slowdown in both domestic consumption and exports. The downturn in the economy will continue in the first half of 2007. Two scenarios of U-shaped and L-shaped changes are expected for the second half of the year, depending on the direction of the economy. There is a high possibility that the economy will get for the better, albeit feebly, in the second half of the year absent internal or external shock factors, considering the base effect, which refers to the phenomenon in which the current economic situation is influenced by that in the same period of the preceding year. In such a case, the nation's economic growth rate will stand at about 4 percent. Under the L-shaped scenario, the growth rate may drop to the 3 percent level, with the Government's inability to cope with changes in the economic situation

and sharply worsening situations in the world economy, international oil price, fluctuation in exchange rate, and North Korea's nuclear program.

Continued sluggishness in domestic consumption : In 2007, the growth rate of the private consumption will drop to about 3 percent from about 4 percent in the preceding year amid a decrease in people's asset and earned income and a rise in price. Asset income effect will be only feebly felt due to the continued shrinkage of the real estate market caused by the Government's stringent measures against recession and low interest rates amid the recession. Earned income growth will also remain stagnant amid sluggishness in corporate investment following the recession in both the domestic consumption and exports and the low level of creation of new jobs. People's consumption power will decrease considerably following the continued increase in household debts. At the end of September 2006, household credit balance stood at 558.8 trillion won, with household debts coming to an average of 34.76 million won, a record figure. Private consumption is highly likely to drop, as the effect of a rise in purchasing power associated with the local currency's strength will be offset by the effect of a drop in real purchasing power associated with a rise in price.

As for facility investment, it will post an anemic growth rate of lower than 5 percent due to insufficient improvement in relevant systems, such as the regulations prohibiting conglomerates from holding significant stakes in other companies or limiting the establishment of factories in the

Greater Seoul area, political and social unease, and worsening business morale affected by the recession both at home and abroad.

Construction investment is expected to post about 1 percent growth rate due to the recession in the private real estate sector despite of an increase of investment in the public sector. The private housing market will inevitably shrink under the impact of the Government's stringent measures against real estate speculations. A favorable factor will be investments in the public sector, such as New Multi-functional Administrative City, Corporate/Innovative Cities, New Towns, whose effect will become more apparent from the second half of 2007. Under such circumstances, the construction investment will post a positive, albeit feeble, growth in 2007. The effect of technical rebound from the negative growth in the preceding year will also have an impact on the growth in 2007.

Continued uneasiness in job market : In 2007, the job market will remain very sluggish, despite the Government's efforts to increase jobs in the public sector, due to the weakened trend in the creation of jobs amid the downturn of the economy. Overall employment is not likely to improve due to the difficulties stemming from anemic corporate investment and the slowdown of the economy. By sector, the employment prospect will be particularly bleak in the manufacturing sector. The service sector, which has served as an important source of new jobs, will also be affected considerably by the downturn of the economy.

Likely price hike : Continued rise in the price for imported goods will drive domestic commodity price higher despite the sluggishness of the

economy. In 2006, the growth rate of the Won-denominated price for imported goods posted a double-digit figure under the impact of high international oil price. The price of imported goods will continue to remain high in 2007. However, the sluggishness of the domestic economy and the Won's strength will have some dampening effect on the trend of price hike.

First current account deficit in ten years : The foreign trade sector, which has served as a driving force for the nation's economic growth, is expected to post a current account deficit in 2007 for the first time since the financial crisis due to the downturn in exports, an increase in crude oil import, and an increase in service account deficit. It is expected that exports will go down under the impact of a slowdown of the economy of the U.S. and China, major importers of the goods manufactured in Korea and an increase in trade frictions. In contrast, imports will post a modest growth despite the sluggishness in the domestic economy due to high oil price. Imports of consumables and capital goods will not increase conspicuously due to the slump in private consumption and corporate investment. Raw material imports, which account for more than half of entire imports, will continue to post a high growth under the impact of high oil price. The domestic service account, which suffers chronic deficit due to the weakening competitiveness in travel and education, will experience another year of deficit in 2007. In the event that the local currency remains strong, more Koreans will spend more foreign exchange outside the country. Under such circumstances, current account is likely to record deficit for the first time in ten years.

Higher volatility in financial market

The domestic financial sector is expected to exhibit signs of misalignment with changes in the supply-demand situation in the market amid the expected sluggishness in the market.

Stock market remaining bullish : In 2007, the domestic stock market is expected to remain bullish amid a drop in interest rate and an increase in the demand for installment-type investment funds. However, there is every possibility that investment psychology may abruptly cool-off due to the recession of the domestic economy and problems related to North Korea's nuclear program. Interest rate will remain low under the impact of the FRB's halt to the procession of interest rate hike in the U.S. and the sluggishness of the domestic economy. Under such circumstances, it is expected that funds will be attracted to stock-type ones offering relatively higher profitability. Still, there is no ruling out the possibility that the flow of funds into capital market may be limited because of private sector's poor performance and stagnation in household income. There may also be a stampede of foreign investors' funds out of the domestic capital market if North Korea's nuclear program leads to another crisis.

Factors for Won's sharp gain or drop : Prospect for the Won's value against the Dollar remains very uncertain in 2007. The continued current account deficit of the U.S. will serve as a factor driving the value of the Won as well as the Chinese Yuan and the Japanese Yen higher. The Won may gain to the level of 800 won per the U.S. dollar in line with international investment banks' forecast about the Yen's appreciation. However, the opposite situation cannot be ruled out, if there is a drastic increase in geopolitical risks associated with North Korea's nuclear program in addition to other unfavorable factors, such as the slowdown of the domestic economy and current account deficit. The Won is expected to drop against the yen unlike in 2006, as the Japanese economy will continue to recover. The economic recovery will drive interest rates in that country higher, while Japan continues to enjoy the expectedly large amount of current account surplus. Thus, the yen will gain against the Dollar faster than the Won does.

Drop in interest rate due to recession : Domestic interest rate will drop slightly amid a slowdown in exports caused by the global recession and a downturn of the domestic economy due to sluggishness in consumption and corporate investment. In the event of continued slump in exports and domestic consumption, it is not very likely that the Bank of Korea will raise benchmark interest rate, despite a rise in real estate price. Major foreign investment banks predict that the FRB may lower prime rate in 2007 in connection with the expected recession of the U.S. economy, which will serve as a dampening factor on a rise in interest rate in Korea.

< Prospects for Major Macroeconomic Indicators in 2007 >

		2005(P)	2006(E)	2007(E)		
Inter-national indicators (IMF)	World Economic Growth Rate (percent)	4.7	5.1	4.9		
	U.S. (China)	3.2 (10.2)	3.4 (10.0)	2.9 (10.0)		
	Japan (E.U.)	2.6 (1.3)	2.7 (2.4)	2.1 (2.0)		
Domestic Indicators	National Account	Economic growth rate (percent)	4.0	4.8	4.2	
		Final consumption expenditure (percent)	3.4	4.2	3.7	
		Private consumption (percent)	3.2	4.1	3.5	
		Gross fixed capital formation (percent)	2.3	2.9	2.5	
		Construction investment (percent)	0.4	0.5	1.5	
		Facility investment (percent)	5.1	7.5	4.5	
	Foreign Trade	Current account balance (\$ billion)	166	30	-30	
		Based on customs clearance	Trade balance (\$ billion)	232	170	100
			Exports (\$ billion)	2,844	3,250	3,550
			Exports Growth rate (percent)	(12.0)	(14.3)	(9.2)
			Imports (\$ billion)	2,612	3,080	3,450
			Imports Growth rate (percent)	(16.4)	(17.9)	(12.0)
	Others	Consumer price (Average, percent)	2.7	2.5	2.8	
		Unemployment rate (percent)	3.7	3.5	3.7	
	Finance	Won-dollar exchange rate (Average, won/dollar)	1,024	955	925	
Government bond interest rate (Average, percent)		4.3	4.6	4.4		

Big difference in briskness by sector

Looking at business prospects by sector in 2007, the semiconductor and shipbuilding industry will continue doing well, while the automobile, information technology (IT), machinery, logistics and maritime sectors will maintain a level similar to that of 2006. The construction sector is expected to be stagger from getting out of the recession as in past few years.

(Sectors expected to do well)

Semiconductor enjoying favorable situation amid short supply : In 2006, the domestic semiconductor industry as a whole enjoyed a good year. As for DRAM⁵⁾, its price stayed solid despite of the recession in the PC industry, a core frontline industry for DRAM, due to the supply shortage in markets worldwide following the disruption to the process of shifting the production process in German and Taiwanese firms, which are the nation's major competitors. Production of flash memory devices⁶⁾ increased sharply amid a rapid growth of the digital product market.

In 2007, the DRAM sector is expected to continue to enjoy a good year, on the back of an increase in the demand for PCs following the introduction of WINDOW VISTA, Microsoft's new computer operating system. According to Gartner, a world-famous semiconductor market survey firm, the worldwide demand-based supply quantity of DRAM will decrease from 100.1 percent in the first quarter of 2007 to 96 percent in the fourth quarter of the same year,

5) DRAM is a type of random access memory that stores each bit of data in a separate capacitor within an integrated circuit. Since DRAM loses its data when the power supply is removed, it is in the class of volatile memory devices.

6) Flash memory is a form of non-volatile computer memory that does not lose its data even if the power supply is removed.

meaning a favorable year for the sector amid a rise in price following the supply shortage. The flash memory sector will also see an increase in production on the back of an increase in the demand for digital goods in the world.

Under such circumstances, Samsung Electronics and Hynix, the nation's leading semiconductor manufactures, will play a leading role in worldwide memory device markets and serve as a locomotive for the domestic semiconductor industry. Samsung became the world's first developer of 16-chip Multi Chip Package (MCP)⁷⁾ and 16 gigabyte nand flash⁸⁾, thus securing unique competitiveness in memory semiconductors. Hynix is also expected to enjoy higher profitability, with the greater share of high value-added special DRAM products in its entire production.

Shipbuilding continuing to enjoy brisk business on back of orders from BRICs : In 2006, the nation's shipbuilding industry remained at the top of the world in terms of production volume (43.0 percent), amount of order won (50.0 percent), and amount of existing order backlog (38.6 percent), pushing aside competitors by a wide margin. Thus, exports stood at the record high of \$22 billion. The briskness of business in the sector is attributable to an increase in the demand for long-distance transportation of crude/refined oil amid the run-up of oil price, including a sharp increase in the demand for LNG (liquefied natural gas) transportation, and an increase in the demand for offshore plants for deep-sea oil field development. Offshore plants refer to facilities for exploration, refining, and transportation of crude oil.

7) This semiconductor multi-chip package can store 16 memories in a single package, making it possible to store a large amount of contents in a small-sized device. It is useful for mobile digital devices, including cellular phones.

8) Nand flash memory is a type of flash memory that does not lose its data even if the power supply is removed. Its internal cells are serially connected with each other.

In 2007, international oil price will be a crucial factor for the market situation of the shipbuilding industry. Oil price is expected to show a rising trend due to the problem related to the unbalance in the supply-demand situation of the market. As the nation's shipbuilders recorded a very high growth in 2006 with their operational capacity reaching the saturation point, orders won by them will post a decrease. They will focus on winning high value-added ships, such as LNG carriers.

The shipbuilding industry is expected to enjoy briskness of business even from a mid- and long-term viewpoint. Such an optimistic forecast is based on the prospect of a stronger flow of free trade and the rapid economic growth of BRICs, which will cause an increase in the worldwide ocean-based cargo volume. It is feared that the world may be faced with the supply glut problem from 2008 as China is increasing the shipbuilding capacity to a large extent. As for new high value-added products in the sector, super-luxury cruise vessels and new-concept cargo carriers, such as gas hydrate carriers⁹⁾ or clean ships¹⁰⁾, are expected to gain more pronounced presence in the market.

(Sectors expected to maintain status quo)

Automobile industry will see a slump in both domestic consumption and exports due to high oil price : In 2006, the automobile sector posted only a modest growth both in domestic consumption and exports due to high oil price, continued domestic recession and extended labor strike at Hyundai Motor despite the expectation of economic recovery early in the year. In contrast,

9) A natural gas hydrate (NGH) is a crystalline solid consisting of gas methane molecules surrounded by a cage of water molecules at a low temperature and pressure.

10) A clean ship is a ship designed to prevent or minimize environmental pollution.

imported cars had their market share in Korea increased to a considerable extent as a result of aggressive forays into the market and the Won's appreciation.

In 2007, both domestic consumption and exports will experience sluggishness amid the high possibility of rebound in international oil price and the expected recession in the domestic economy. Exports are expected to post only a modest growth, as the economy of the U.S., one of the nation's major export destinations will slide into a slump, particularly in the domestic consumption. Imported cars are expected to continue to post a high growth, considering the fact that they will not be affected greatly by the downturn of the domestic economy, as their customers are mostly from high-income bracket.

Fall of growth rate due to slump in information technology sector and U.S. economy : In 2006, the domestic IT sector, particularly those engaged in wireless communication equipment PC and PDP (Plasma Display Panel), enjoyed a good year. The brisk business in mobile communication devices was chiefly attributable to a sharp increase in the number of consumers replacing their cellular phones with new models in connection with the Government's permission given to the business for payment of handset-related subsidy to their customers.

Such a trend will continue in the information technology sector in 2007, but the growth of the sector will slow down under the impact of overall economic slump. The expected slowdown of the world economy, including the U.S. economy, will put a damper on the export growth rate. However, the wireless communication device sector will do better than other information technology sectors in connection with the commencement of new services, such as Wireless

Broadband Internet (WiBro)¹¹⁾ and High Speed Download Packet Access (HSDPA)¹²⁾, as well as the expansion of the Digital Multimedia Broadcasting (DMB)¹³⁾ service areas.

Sluggishness expected in machinery amid anemic facility investment : In 2006, the domestic machinery sector saw a good year in exports on the back of an increase in demand from the U.S., China, and Japan. However, most of the machine manufacture relied heavily on the imported core parts for their production, which brought about the odd relationship that an increase in the nation's machinery exports leads to in the machinery imports.

In 2007, the sector is expected to see a slump in both domestic consumption and exports unlike in 2006. Exports will inevitably slow down due to the slowdown of the world economic growth, particularly in the US economy, the largest importer of Korean machinery. Domestic consumption will remain sluggish amid expectedly anemic facility investment under the impact of insufficient improvement in investment-related systems and continued political and social unease.

Logistics facing worsening profitability due to slump in domestic consumption and high oil price : In 2006, the logistic sector saw its growth deteriorate considerably under the impact of the sluggishness in domestic consumption. However, the business engaged in consigned logistics¹⁴⁾ posted a

11) WiBro, a type of high-speed wireless Internet service, makes it possible to be connected with the high-speed Internet while moving.

12) HSDPA is the 3.5th generation of mobile communication method, which enables a user to send and receive data via cell phone at the speed of 10Mbps.

13) DMB, which provides voice and image signals in a digital method, makes it possible to receive signals while moving.

14) Also called the third-party logistics, consigned logistics, refers to the outsourcing of the logistics business for a given period.

solid growth, as domestic companies started using the particular method more than before in an effort to improve their management conditions.

In 2007, the sector will inevitably see a downturn amid the domestic recession and the high oil price. However, the third-party logistics business is expected to continue to do well, as domestic firms will increase the share of this method to reduce their relevant expenses.

Maritime sees slowdown due to fierce competition : In 2006, the nation's maritime industry underwent a slump due to the ever-fiercer competition between large-sized shipping companies, despite of the China effect. The competition was carried out in the form of business expansion, for instance through the merger of Maersk Line¹⁵⁾ and P&O Nedlloyd¹⁶⁾, large shippers' reorganization of their global liner service, strengthened collaboration between shippers, and the securing of large-sized ships. As a result, freight charges fell despite of the China effect (referring to a sharp increase in the volume of ocean freight associated with the rapid growth of the Chinese economy).

In 2007, the domestic maritime sector is expected to continue to enjoy the China effect, as the Chinese economy will continue to post a high growth rate, maybe with a small drop from the preceding years. Elsewhere, the sector will not be able to see improvement in overall business because of the ever-fiercer competition between large shippers

15) Maersk Line was launched as the largest shipper in the world as a result of Copenhagen-based Maersk Sealand's merger of the world's third largest shipper P&O Nedlloyd.

16) P&O Nedlloyd used to be the world's third largest maritime business headquartered in London.

and the expectation that the U.S. economy will slow down, particularly in the housing sector.

(Sectors expected to slow down)

Construction : In 2006, the construction sector struggled from the continued recession particularly in the private sector under the impact of the Government's stringent measures for stabilization of real estate price. The share of social overhead capital investment in the Government's fiscal expenditure dropped considerably. Disruption occurred to the Government's comprehensive investment projects, which were scheduled to commence in the second half of the year, due to lackluster participation of private business. Thus, the public sector failed to go a long way toward complementation of the private sector's effort to shake off the business slowdown.

In 2007, construction in the private sector is judged to remain sluggish under the impact of the Government's stringent measures against real estate speculation, although there exist some favorable factors, including the commencement of the New Town Project in Gangbuk, Seoul. The public sector will benefit from several upside elements, such as the construction of public rental apartments and commencement of BTL (build-transfer-lease) projects. The problem remains, however, because it is uncertain whether private firms are willing to participate in these projects that do not guarantee high profit.

< Business Prospects for Major Business Sectors in 2007 >

		Domestic consumption	Exports	Overall production	Remarks
Sectors expected to enjoy good business	Semi-conductor	☁☀	☀	☀	·Worldwide supply shortage of DRAM ·Increase in demand for flash memory
	Ship-building	☁	☀	☀	·Briskness particularly in demand for oil tankers and LNG carriers
Sectors expected to maintain status quo	Car-making	☁	☁	☁	·Continued high oil prices
		4.5→3.1	3.7→2.7	5.7→2.8	·Slowdown of both domestic and world economy
	IT	☁	☁☀	☁	·Briskness in export of digital wireless communication devices
		9.6→4.9	6.2→5.7	8.5→3.3	·Slowdown of world economy
	Machinery	☁	☁	☁	·Sluggish domestic facility investment
		3.2→2.6	14.4→4.5	5.2→4.8	·Slump in world economy
Logistics	☁	-	-	·Domestic recession	
	4.1→3.8	-	-	·Increase in third-party logistics	
Maritime	☁	☁	☁	·Slump in world economy	
	-29.3→-15.0	-18.9→-10.0	3.0→-5.0	·Rise in expenses, including high oil prices	
Sectors expected to slow down	Construction	☁			·Continued decrease in private building projects
		-7.1→-0.4			·Continued slump in overall construction business

Notes: 1) Figures for 2006 are estimated ones and those for 2007 are based on expectation. Figures for exports and overall production for cars are not inclusive of knockdowns.

2) Domestic consumption in the case of shipbuilding is based on orders won. As for maritime, domestic consumption is based on the market situation for container ships, exports on dry general cargo ships, and production on oil tankers.

3) "☀" refers to a grow rate of 10 percent or higher, "☁☀" to a growth rate of 5~10 percent, and "☁" to a growth rate of less than 5 percent.

Contraction in inter-Korean economic cooperation

Continued economic cooperation with North despite nuclear crisis :

In 2006, the economic cooperation between the two Koreas posted a record amount as a result of a sharp increase in bilateral trade and the South's economic support, including activities related to the Gaeseong Industrial Complex, though there were some dampening factors, such as the North's launch of missiles and nuclear test.

By the end of October 2006, economic cooperative projects between the two Koreas amounted to the record-high of \$1,169.3 million, to mark a 33.5 percent year-on-year increase. Bilateral trades increased by 35.2 percent from the preceding year on the back of brisk activities related to the Gaeseong Industrial Complex and processing-on-commission trade, despite a 32.0 percent decrease in the Mt. Geumgang tourism business following the North's nuclear test. Looking at the Gaeseong Industrial Complex, with the completion of the work for site preparation and commencement of operation of eighteen business, the import of goods produced in the complex to the South showed a phenomenal growth rate of 467 percent from the preceding year, while exports from the South to the complex recorded only a modest growth. Thus, in transactions involving the complex, imports from the South increased by 60.7 percent while exports to the North increased by 12.7 percent from the preceding year. As for general trade between the two, the total trade amount increased by 50.6 percent from the preceding

year, while the number of firms and the items traded decreased by 7.4 percent and 3.1 percent, respectively.

It should be pointed out that the inter-Korean economic cooperation accounts for a high percentage of non-commercial transactions, including unilateral support from the South, a trade structure heavily dependent on specified items and highly susceptible to non-economic factors. By the end of August, non-commercial transactions decreased by 27.6 percent year on year, with the Government's suspension of the provision of rice and fertilizer, following the North's launch of missiles. However, in September alone, the support for the North related to the flood-caused damage from the private sector stood at \$216 million, causing the support for the North to increase by 30.1 percent from the preceding year in the January ~ October period. Thus, non-commercial transactions in the economic cooperation between the two Koreas increased to 34.8 percent. The bilateral trade shows heavy dependence on specified items, with primary products (i.e. agricultural/forestry/marine/mineral products), textiles, chemical goods (mostly fertilizer supplied from the South) and iron/steel/metal products used for construction in the Gaeseong Industrial Complex accounting for 81.5 percent of the entire trade. At present, there are also matters of concern that should be addressed regarding the North's cooperative attitudes, such as the ongoing suspension of the tourism project involving Gaeseong caused by the North's unilateral demand for a change in the relevant business of the South and the termination of the construction work for the meeting place for the dispersed families at Mt. Geumgang.

< Trade between Two Koreas by Type >

(Unit: Million Dollars)

	Commercial transactions				Non-commercial transactions	Total
	General trade	Processing-on-commission trade	Economic cooperation	Sub total		
1995	230.4	45.9	0	276.3	11.0	287.3
2000	110.5	129.2	33.6	273.3	151.8	425.1
2001	111.4	124.9	18.9	255.2	147.8	403.0
2002	171.8	171.2	25.0	367.9	273.8	641.7
2003	223.7	185.0	21.0	429.7	294.4	724.2
2004	171.8	176.0	88.7	436.5	260.5	697.0
2005	209.8	209.7	270.0	689.5	366.2	1,055.8
January ~ October 2006	248.6	212.9	300.6	762.0	407.3	1,169.3
(Growth rate)	50.6%	23.3%	33.0%	35.2%	30.5%	33.5%

Notes: 1) Economic cooperation in commercial transactions refer to cooperation involving Gaeseong, Mt. Geumgang and other economic cooperation, while non-commercial transactions include economic support provided by the Government and the private sector, cooperative projects in social and cultural sectors, construction of light water reactors and the supply of heavy oil for KEDO.

2) (Growth rates) are year-on-year figures.

Unlike activities for the Gaeseong Industrial Complex, the project associated with Mt. Geumgang sightseeing and the road linking the two remained sluggish. The number of tourists visiting Mt. Geumgang from the South decreased due to the delay in the opening of the Naeseong area and the golf course, and the spread of negative public opinion associated with the North's launch of missiles. By the end of November 2006, the number of South Koreans visiting Mt. Geumgang stood at 230,000, a 20 percent decrease from 288,000 in the preceding year and short of the target set at 400,000 for 2006.

< Number of Tourists Visiting Mt. Geumgang >

(Unit: Thousands of People)

	1998	1999	2000	2001	2002	2003	2004	2005	January ~ November 2006
Total	10.5	147.5	212.0	58.8	87.4	77.7	272.8	301.8	230.2
- Koreans	10.5	147.4	211.3	58.2	86.9	77.2	270.7	300.0	228.5
- Foreigners	-	0.07	0.8	0.6	0.5	0.5	2.1	1.9	1.7
Accumulated Total	10.5	158.0	370.0	428.9	516.3	594.0	866.8	1,168.6	1,398.8

In the Gaeseong Industrial Complex, a total of fifteen firms, including three factories in the Main Complex, have started operation by November 2006 after three and half years of development. 10,000-plus North Korean workers are making goods worth \$1,340/ person (i.e. about 20 times their individual wage) as of October 2006, compared to \$243/person in 2005. The Gaeseong-based trade between the two Koreas came to 19.9 percent and 30.6 percent of the entire South-North trade and bilateral commercial transactions, respectively, in the January ~ October 2006 period. Nine companies in the Main Complex are building their factories. The site formation work for Phase-1 (one million pyeong = 810 acre) is scheduled for completion by the first half of 2007. The commencement of the work for the remaining 600,000 pyeong in the Main Complex, which was originally scheduled to be allocated in 2006, has been temporarily put off following the North's nuclear test. As for the railroad linking the two Koreas, its test operation was scheduled for May 2006, but was not materialized by the North's unilateral notice for indefinite postponement. It is not predictable when the test operation can take place considering

the current stalemate caused by the North's launch of missiles and nuclear test.

Disruption to economic cooperation feared due to stalemate on nuke crisis : In 2007, non-economic factors, such as political instability and the North's nuclear intention, will play a crucial role in determining the future of the inter-Korean economic cooperation. This will be equally so in projects involving the South's private interest like the Gaeseong Industrial Complex and Mt. Geumgang sightseeing as well as Government-level projects such as construction of railroads and roads linking the two, provision of raw materials for light industries, and joint development of natural resources. Prospects for economic cooperation between the two Koreas depend on the direction of the current crisis situation caused by the North's nuclear intention. Despite the improved basis for the bilateral economic cooperation and the commencement of operation of factories in the Phase-1 Main Complex of the Gaeseong Industrial Complex, the delay in finding a solution to the problem caused by the North's nuclear intention and instability in the relations between the two Koreas will put a damper on the increase in bilateral economic cooperation.

In 2007, further development of the current tension in the Korean Peninsula will have an impact on the direction of economic cooperation between the two Koreas. Based on the principle of separation of economy from politics adopted by both the North and South, the current situation is not likely to have a serious impact on existing economic cooperation projects and bilateral trade, unless the two are

not engaged in a military conflict. However, the Government's provision of support for the North and new economic cooperation projects carried out by private sector will inevitably face difficulties and delays amid the instability of the bilateral relations, the U.S. demand for enhancement of the level of transparency in, and adjustment of speed of the economic cooperation, and the weakening of the originally intended function of inducing changes in the North's regime. The Government suspended the supply of \$360 million worth of goods (i.e. \$270 million worth of rice and fertilizer, \$12 million worth of materials and equipment for construction of railroad/road, and \$80 million worth of light industry raw materials) out of the \$454 million worth of goods originally scheduled to be shipped out in the July ~ September 2006 period. Other measures taken by the Government following the North's launch of missiles and nuclear test include the termination of activities related to the economic cooperation with the North, payment of subsidy to visitors to Mt. Geumgang, and suspension of allocation of land parcels of Phase-2 of the Main Complex of the Gaeseong Industrial Complex. This is feared to cause disruption to promotion of new and existing economic cooperation projects, amid high instability related to the projects and anxiety felt by people. In the event of a summit between the leaders of the two Koreas or substantial progress in the Six-Party Talks, however, an epoch-making step can be taken toward a large-scale economic cooperation related to the light industry and development of natural resources as agreed at the 12th South-North Economic Cooperation Promotion Committee held in June 2006.

V. Five major issues related to domestic economy in 2007 – with the focus on the Government's policy measures

In 2007, it is feared that the following five factors will pose barriers to the domestic economy as felt by the general public: continued low growth/ crisis situation related to household debts, unease over the foreign exchange market/ deficit in current account, fear of the burst of real estate bubble, worsening of public sentiment over the crisis situation in the Peninsula, and popularity-conscious policies taken in connection with the Presidential election.

Continued low growth/ crisis situation related to household debts

It is expected that the structural problem of the labor market will worsen. It will be difficult to solve the problem of large youth unemployment due to the economy's inability to create jobs under continued low growth and an expected increase in the number of irregular workers¹⁷⁾. Another factor that puts a damper on the market-sensed economy is huge household debts, 558.8 trillion won at the end of September 2006, the highest record in the nation's history. The figure indicates a 2.6-fold increase from a decade ago 58 percent of that amount is mortgage loans. In the event of the collapse of the real estate bubble, households, business and financial companies will be equally facing difficulties, which may lead to a dire financial crisis. The sharp increase in household debts is caused by the collapse of the middle class amid the continued low growth, which results in credit delinquents and bankrupt individuals. Fundamentally,

17) The nation's employment rate based on the OECD criteria stood at 63.7% in 2005 much below the OECD average (65.5%). Thus, the nation ranks the 20th among the 30 OECD countries. Based on the nation's own criteria, the employment rate comes to 59.7% in the January ~ October period 2006, compared to 59.8% in 2004 and 60% in 2002.

low-income people, whose asset/ earned incomes are at a paltry level, could maintain their consumption power only by borrowing money. The increase in mortgage loans in the frenzy of real estate speculations also served as a reason for the increase in household debts. The problem is that such huge household debts may put a limit on the financial policies adopted by the monetary authorities. When there arises a need to raise interest rate due to price instability or unsettling situations in the real estate market, the rise in interest rate will lead to an increase in households' debts, which will in turn deepen the problem of a slump in consumption in a vicious cycle.

To solve such a problem, jobs should be created through invigoration of the economy. This requires an increase in corporate investment. It is particularly necessary to invigorate investment by conglomerates, as they play a leading role in private investment. Thus, an environment conducive to corporate investment should be fostered through the abolition of the rules prohibiting conglomerates from holding significant stakes in other companies, mitigation of regulation over establishment of factories in the Greater Seoul area, and the reduction of environment-related expenses allocated to a business establishing a factory or other expenses thus allocated. Tax should be reduced or exempted and the system of granting approvals and authorizations should be simplified to help more people open venture business and SMEs and invigorate investment in them.

There is a need for soft landing for the construction sector. The Government's stringent measures against real estate speculations have posed barriers to construction investment without having a positive effect on real

estate price stabilization. A slump in the construction sector, which has a high employment effect, directly leads to a worsening employment situation. Diversified policies, such as an increase in SOC (social overhead capital) investment and provision of support for small-sized construction firms, should be adopted to facilitate a soft landing of the construction sector.

Preventive measures should be taken against abrupt shrinkage of the consumption sector. The recent increase in the volatility of the domestic economy is attributable to the sluggishness in domestic consumption, which failed to play the role of a buffer against the shock of changes in the economic situation caused by non-economic factors. Recovery in consumption should come from supplementation of people's real consumption power. Imposition of an excessive tax burden in the period of economic downturn will reduce disposable income of households.

It is particularly important to set up comprehensive measures against the problem of household debts, including the constant monitoring of the relevant situation and making up for deficiencies of the existing credit resuscitation system. It is also necessary to temporarily lower the requirements of those eligible for the consumer credit resuscitation system, including "bad bank" or individual bankruptcy, as the current system appears to have a low policy effect due to a limited range of target subjects. More fundamentally, measures should be taken to put an end to the current situation in which funds, including borrowed money, are concentrated on the real estate market. A structure of virtuous cycle of funds in the market in which funds are supplied to the stock market should be established.

Unease in foreign exchange market and current account deficit

Domestic business will see an increase in foreign exchange risk due to an increase in the volatility of the Won-Dollar exchange rate amid the downturn of the domestic economy, geopolitical risk in the Korean Peninsula and the Dollar's weakness against major currencies. Goods exported from Korea still remain heavily dependent on price competitiveness, despite much improvement from the past. Exchange rate is a determining factor for the profitability of exporting companies. In the 2001 ~ 2004 period, the Won gained at a modest rate of 50 won/dollar on an annual average. In 2005, the rate of gaining rose sharply to 120 won/dollar. In 2006, the Won stood at 960 against a dollar on an annual average. In 2007, the Won is expected to continue on the rising trend.

The continued appreciation of the Won will result in an increase in current account deficit. It will weaken the price competitiveness of goods exported from Korea and cause a slowdown in the nation's export growth. At the same time, it will enhance the Won's purchasing power and cause an increase in imports. Thus, it is likely that the nation's trade surplus will decrease drastically. The sharp increase in the number of outbound travelers and those choosing to study abroad will increase the service account deficit, due to the low international competitiveness of the tourism, leisure, and education industries of the nation. Thus, the nation will see current account deficit for the first time after the financial crisis in 1997 and 1998. Failure or delay in the ongoing FTA negotiations with the U.S. whose deadline is set for March 2007 will aggravate the bilateral trade relations between the two countries and cause

problems in the nation's exports to the U.S., causing an increase in current account deficit¹⁸⁾.

Under such circumstances, the Government should make all possible efforts to stabilize the foreign exchange market. Measures should be taken against sharp fluctuations to help alleviate domestic firms' burden associated with exchange rate risks. It is also necessary to encourage diversification of international payment currencies so that the companies may depend on the Dollar less as a means of international payment. The Government should reinforce the monitoring of the in/outflow of capital to exercise proper control of speculative capital in connection with the liberalization of the foreign exchange market. It is very important to conclude the FTA with the U.S. successfully, as the nation's future economic situation heavily depends on it. Thus, the Government should express its strong commitment to the success in the FTA with the U.S., explaining its positive effect to the people.

Increased fear of the burst of real estate bubble

Domestic real estate price has shown a steady rise since the second half of 2001. In response, the Government has taken stringent real estate price stabilization policies as announced on several occasions, including the one announced on August 31, 2005. Despite such policies, the price for

18) In the January ~ November 2006 period, for example, the amount of the nation's exports to the U.S. stood at about \$40.9 billion, accounting for 13.3% of the entire exports, making the U.S. the No.2 destination of Korean exports (after China, which accounted for 21.5% of the entire exports).

apartments, particularly those in Gangnam, Seoul, rose sharply, deepening the bipolarization in the real estate market by region and apartment type and size. On November 15, 2006, the Government announced additional measures against a rise in real estate prices, including the raising of banks' reserve ratio requirement and imposition of more stringent conditions for mortgage loans by the Bank of Korea, along with a plan to increase the number of apartments supplied in the Greater Seoul area. Considering the fact that it takes two to three years for a housing-related policy to take effect, it will be difficult to expect to see stabilization of real estate price in the near future. The unstable supply-demand situation in the Greater Seoul area and the expectation of mitigation of regulations associated with the Presidential election in 2007 also pose a dampening factor for real estate price stabilization. On a mid- and long-term basis, however, real estate price is expected to be stabilized amid a decrease in expected profitability related to real estate speculation and the increase in the number of apartments supplied. It is also expected that the real estate market will go through an adjustment period for two years from 2008 with the completion of the work for New Town Phase-1 and refurbishment project for Jamsil apartment complex in Seoul and Pangyo New Town.

Looking at Japan, real estate price plummeted as a result of a variety of measures taken for real estate price stabilization in the early 1990s. A near-crisis situation followed, with households unable to pay back their money borrowed from banks, resulting in the collapse of many financial

institutions. At present, the LTV(loan-to-value) ratio stands at 40 ~ 60 percent in Korea, compared to 100 percent in Japan in the early 1990s, meaning that the possibility of a sharp drop in real estate price is lower than in Japan at that time. However, a sharp drop in real estate price following a drastic belt-tightening measure taken may cause the reverse-wealth effect, resulting in a slowdown in consumption, an increase in the number of households filing for bankruptcy, and a crisis situation in financial circles.

In the future, the nation's real estate policies should focus on promoting the stable supply of housings on a mid- and long-term basis based on the market economy principle rather than pushing forth with regulation over specified areas. The policies should be carried out in a way that can stabilize the price gradually, taking into account the fact that real estate is an important means of providing for old age, high real estate price in specified areas are associated with good educational conditions in them, and people with higher income want better housings. For greater effect of such policies, the following measures should be taken: differentiation between regions in the housing supply in consideration with local supply-demand situations, promotion of a policy for dispersion of housing demand in Gangnam, Seoul, temporary mitigation of regulations, such as imposition of heavy transfer tax, recovery of reliability of relevant policies, and establishment of a mid- and long-term roadmap that takes into account changes in the demographics.

Worsening economic sentiment due to unstable political situation surrounding the Korean Peninsula

If the current near-crisis situation in the Korean Peninsula caused by North Korea's nuclear test remains unsettled over an extended period of time, it is likely that the investment psychology of individual people and business will cool off, causing further slowdown in domestic consumption. An increase in political risks will put a damper on foreigners' willingness to invest in Korea, which will aggravate the already less-than-optimal employment situation. Recently, the nation's economy has been frequently jolted by external shocks, such as fluctuations in foreign exchange rate, high international oil price, and geopolitical instability in the region, because the basis for domestic consumption is not solid enough to withstand them.

The Government should take measures to enhance its crisis management ability in preparation for the situation caused by a change in the attitude of either the North or the U.S. and reinforce mutually collaborative relations with neighboring countries. The Government should make a continued effort to urge the North to give up its nuclear program, proposing substantial incentives, while joining in the international community's stringent step taken against the North if it delays actions required to settle the crisis situation caused by its nuclear intention or carries out additional nuclear tests. The Government should also play a more active role in solidifying the alliance relations with neighboring countries and the U.S. and in finding more constructive alternatives that will encourage the North to adopt positive changes in cooperation with the U.S.. It should also make all possible effort to reduce the gap between the South and the U.S. in the

way they look at the North's nuclear program, not to have the South excluded from negotiations related to it, and re-establish relations with the U.S. in matters concerning relocation of the U.S. military base in Korea, and takeover of the right for wartime operational command from the U.S. through the enhancement of its risk management ability.

In addition, it is high time that the Government should take steps to check and complement the financial early warning system, the State Crisis Management System and the National Emergency Plan, established in the wake of the financial crisis to prepare for situations caused by changes in external factors, such as fluctuation in exchanges rates and high oil prices.

Popularity-conscious policies associated with Presidential election

Finally, in 2007, there is a high possibility that many popularity-conscious, ineffective policies are adopted. Such policies, which are likely to lack consistency, will cause confusion between Government ministries, thus increasing the uncertainty over the economy. As popularity-conscious measures are likely to lead to anti-business sentiment, which will in turn discourage business' domestic investment and accelerate the exodus situation (which refers to the establishment of business facilities in foreign countries leaving domestic facility investment stand still since the financial crisis)¹⁹⁾. If such a situation continues, the economy will not be able to escape the low-growth trap amid the lack of growth potential caused by the anemic capital accumulation²⁰⁾.

19) The nation's overseas investment jumped from \$3.69 billion in 1997 to \$6.72 billion in 2005 and to \$7.5 billion in the January ~ September period of 2006.

In connection with the Presidential election slated for 2007, it is likely that many popularity-conscious campaign pledges will be made political considerations will be included in formulation of economic policies and the process of their implementation as well. Economic policies must maintain rationality based on economic principle. Also, precautions should be taken not to cause unease in the market by reinforcing the Financial Ministry's function of coordinating economic policies and to prevent policy confusions made between the ruling party and the Government in matters related to their respective view of the current economic situation, corporate regulations, and tax policies. The Government's corporate policies should be taken in a way that respects self-regulation in the private sector to the utmost possible extent. Urgent steps should be taken for abolishing the system that prohibits conglomerates from holding significant stakes in other companies, mitigating regulations over establishment of factories in the Greater Seoul area, and reducing expenses allocated to the business establishing factories to foster environment conducive to corporate investment. Fair trade policy should be focused on establishment of the market economy principle, such as correction of monopoly situation in market and protection of consumers, rather than on governance structure of business. In promotion of economic policies, emphasis should be made on Total Solution Policies, which fully consider their impact on the overall economy.

20) It took the U.S., the U.K., and Germany about ten years to enhance their per-capita GNI from \$10,000 to \$20,000, while it took Japan and Singapore about five years to do similarly. The difference in the time taken for the same goal is chiefly attributable to the difference in the facility investment growth rate (i.e. an average of about 4% in the case of the U.S. and European countries, compared to a higher rate of about 10% in the case of Japan and Singapore).

VI. Laying firm foundation for economic advancement focusing on growth, market, and reconciliation

The current problem of the Korean economy, i.e. being caught in a low-growth trap, is basically attributable to its inability to adapt to changes in external condition in the 21st century in which the cold war system is dissolved, the free market principle putting emphasis on efficiency and competition is spreading fast as the universal economic ideology, and a knowledge-based society is rapidly formed. At present, the Korean society finds itself unable to adapt to changes made in the outside world in a timely manner amid the confusion of values and confrontations between generations and people from different backgrounds, thus causing dilapidation of the political, economic, and social system.

Growth, free market, and reconciliation should be policy keywords of the Government in New Year

In 2007, the nation must make all possible in forming of new growth engines ("growth"), development of the free market economy through maximization of economic resources ("free market"), and consolidation of national strength ("reconciliation") to escape the low-growth trap and take a step forward to join the ranks of more advanced nations.

Formation of new growth engines ("growth") : First of all, the nation's economy should get past the growth pattern fixed by the input amount of labor and capital and move toward an innovation-based advanced

growth stage through the development of new growth engines.

The nation should adopt growth-centered economic policies. It is difficult to sustain a zero-sum type of allocation policy that focuses on simple transfer of wealth from one part of society to another without growth. Such a policy ends up having resources used in allocation depleted. The nation should establish a non zero-sum type of growth strategy that guarantees sustainable allocation of wealth through the expansion of overall wealth on the back of enhancement of growth vitality of the entire society.

The nation should also explore promising, future-oriented industries with high added value and growth potential that can do well in the social and economic environment of the 21st century and help them grow on a mid- and long-term basis. Those emerging as next-generation growth industries are: the information technology and bio technology sectors (accompanied by rapid technological innovation), the environmental technology and culture technology sectors (that fit the period of the aging society and stressing the importance of environment), and the nano technology sector (designed to create new materials through manipulation and processing on an atomic level). It is necessary to focus on the development of information /telecommunication, micro-sized electronic devices, multimedia, alternative energies and bio science in consideration of the reality of domestic industries and their industry-related effect. To that end, a new support system should be established that will mitigate

regulations over corporate capital stock for companies engaged in new growth industries and allow business to establish various forms of companies. Especially, regulations over capital need to be mitigated in an epoch-making way so that venture capital can be utilized as a growth engine through the capital market.

However, it should be noted that a simple shift to what is called hi-tech industries or knowledge-based industries does not necessarily provide the nation with absolute superiority in competitiveness. Efforts should also be made to advance the nation's core industrial sectors, including automobile and semiconductors currently enjoying the economy of scale, posting high added value through integration of high-end technologies and managerial innovation.

A new development strategy should also stress the importance of inter-complementary, cooperative relations between conglomerates and SMEs jointly engaged in activities for the nation's economic growth. SMEs, including venture business, offer the advantage of fully exploiting their creativity and flexibly coping with changes in environment. However, they alone are not able to solve the problems associated with employment or export competitiveness. In an era of limitless competition and borderless market, the nation should make drastic efforts to help conglomerates enhance their capability for supplying funds, making investment, and boosting efficiency in resource utilization and their images as world's leading firms.

Sophistication of the service sector is another project that should be promoted urgently to haul in a rapid growth of the economy. The service sector plays the role as the softener of the economy, in addition to creating many jobs. With the development of the economy, the share of the service sector in the entire industry gets larger. However, a considerable proportion of the nation's service sector is still occupied by non-entrepreneurial self-employed business not associated with high added value. That is to say, the domestic service sector is not able to play the role as a growth engine, despite of its large size. To solve this problem, the Government should reinforce policy-based efforts to invigorate service sectors that can create high added value, such as knowledge-based services and those engaged in providing support for the manufacturing sector.

The nation's inability to escape the low-growth trap is attributable to the lost link between the market-sensed economy and the financial market, which blocks the inflow of ample liquidity into productive sectors. To solve such a problem, the virtuous circle structure for funds should be established by taking measures to relocate floating funds to productive sectors through the provision of support for domestic investment banking business, the development of large-sized credit rating business, and the improvement of the expertise in services provided by investment banks.

The nation's economic growth heavily depends on exports²¹⁾, and the nation's export industry has a lot of problems. China and a small number of industrialized countries are major importers of Korean manufactured goods. The nation should adopt an export policy that encourages business to diversify their markets to new targets, including BRICs and TVT.²²⁾ Conditions for export should be improved drastically through the aggressive promotion of FTA's with as many countries as possible, including the U.S. with which the negotiation is scheduled to be concluded within the first half of 2007.

Development of free market economy ("self-regulation") : The nation should overcome the ever-worsening problem of inefficiency in its economy, in addition to the enhancement of the growth potential, if it wishes to join the ranks of more industrialized nations. To this end, the Government should take more positive measures for regulatory innovations, pursue a smaller government, and enhance the productivity of domestic capital, creativity of private business, and efficiency of the economy as a whole.

Most importantly, unnecessary regulations should be abolished to encourage economic activities in the private sector. Regulations over

21) In the 2001 ~ 2005 period, for example, the nation's dependence on exports expressed in exports/GDP stands at 33.2%, compared to its dependence on foreign trade as expressed in imports + exports/GDP stands at 63.8%.

22) TVT refers to Turkey, Vietnam and Thailand.

investment or startups, in particular, should be kept to minimum. Business-friendly environment should be fostered so that they are encouraged to make courageous investment with an entrepreneurial spirit.

The Government should take consistent steps in pursuit of a small and efficient government, limiting its role to enactment of rules for fairness and efficiency, supervision of compliance with the rules, and coordination of conflicts in the process of economic development, instead of trying to play a leading role in the process. To succeed in such pursuit, the Government should reorganize the organizations and functions of its ministries and institutions to make them lean and mean and push ahead with privatization of public corporations.

Consolidation of national strength ("reconciliation") : All components of the society should be united as one through mutual trust and reconciliation to help the nation exert its economic capability to the fullest possible extent. Many watchers of Korea point out that its national strength is wasted due to the continued conflicts and confrontations between various classes of people. The Government should play the role of a coordinator and arbitrator for conflicts made between various parts of society and foster the environment for cooperation between conglomerates and SMEs, urban areas and rural/remote areas.

As for the need to secure funds for putting an end to the income bipolarization, consensus should be reached and efforts should be made for the maximization of policy effect within the framework of the market economy principle. The Government should do its best to maintain social integration by playing the above mentioned the role of an arbitrator and coordinator.

Integral leadership : The nation requires strong leadership to carry out activities for the aforesaid measures, i.e. growth, self-regulation, and reconciliation, by paying equal attention to different public opinions and consolidating their strength. 2007 should be a significant year for the establishment of such solid leadership.

Innovation of socioeconomic system

The political/economic/social systems should be innovated for the nation to reach its goal of joining the ranks of more industrialized countries. To attain such a goal, the principle of legalism should be established for enhancement of mutual trust and reconciliation between all components of the society, innovation should be made in politics, including the election system, global standards should be adopted in all sectors of the society, and the market economy principle should take deep root.

Establishment of legalism for enhancement of mutual trust and reconciliation : In a free, democratic society, law is one of the moral norms that satisfies the minimum moral standards. Promises and principles should be kept and observed. As Francis Fukuyama put it, the future of a country or society is decided by trust relations between its components. Such an important relationship as trust can only be formed when all social and political activities, including traffic regulations, labor-management disputes, and acts of ruling a country, are carried out on the laws and principles.

Election system and political culture asking improvement : Current political system and political culture, which appear to cause only conflicts and confrontation, should be innovated. The public-funded election campaign system should be established to prevent elections influenced by money and to democratize the operation of political parties. Time-worn customs of one-man rule and selection made in a closed room on political candidates should be put to an end through the democratization of political parties' operation. Regionalism should be ended. Civil organizations and mass media should play the role as the watchdogs for the political circles based on law and order.

Adoption of global standards : In the era of globalization, all components of society should act in accordance with global standards, including transparent accounting standards and democratic corporate

governance structure. Realistically, global standards have been set up for the benefits of the large advanced countries. Smaller countries should be united to build solidarity among themselves to be able to voice their interests.

Market economy principle taking roots: First of all, it is important to make the market economy principle take roots. In the era of liberalization and market-opening in which the government's room for measure is limited unlike in the past, it is difficult for the government to run the economy stably through policy-based intervention. An economic policy disregarding the market economy principle that stresses the importance of creativity and efficiency of the private sector comes to distort the economic structure and cause greater operational inefficiency.

Pursuit of innovations for creative education

Efforts to join the ranks of more industrialized countries should go together with innovations in education that befits the knowledge-based era, along with changes in politics, economy and society. After all, advancement of national systems and enhancement of their efficiency depend on how well the members of a society are educated and trained. In the new era, the intellectual ability of people will be the most important of all, and creative value will be made the objective of people's activities. Educational innovation should be carried out to

foster environment that emphasizes diversity, individuality, and the creation of new values. The nation's economy will eventually fall behind the competition if the school education focuses solely on making students enter prestigious universities without stressing the importance of creativity and diversity. Innovation should be carried out in the education and training system in a way that stresses people's creativity and intellectual ability, and for this, uniform equalitarianism in education should be stopped.

No more uniform equalitarianism : Uniform equalitarianism should be stopped downright to make educational innovation possible. Throughout human development, three major types of education are carried out: education for survival in the human society; personality education designed to help people adapt to social life; creativity education designed to help people contribute to development of the society. The current school system appears to adhere to the idea of uniform equalitarianism and lack the care for related to the need to build creativity in students.

Competition-based innovation of education and training system : In the rapidly developing knowledge-based society, the importance of education cannot be overemphasized. Market watchers say that China is closing the technological gap with Korea at a tremendous speed and currently the gap between the two countries is calculated to be 2.1 years. This means that Korea must make drastic efforts to survive the

competition with China as well as with other countries through the strategic development of human capital. As Peter F. Drucker put it, school education is a factor that decides the development of the knowledge-based society. In other words, school education is a determining factor for national competitiveness in the knowledge-based society. Recently, Germany, the U.K., China and Japan, among others, have announced a variety of plans for educational innovation. Their plans are all focused on competition, rather than uniform equality, among students apparently in an effort to educate and train talented young people needed in the knowledge-based society.

Establishment of new values

New values suited to the new era should be established to have people united as one and all available resources should be mobilized in order to attain policy objectives of the Government. The new values should be able to encourage people to take a joint step toward the national vision with cooperative and reconciliatory spirit.

Need for correct understanding of capitalism : In 2006, that people engaged in excessive gambling became the focus of attention. It is indicative of the spread of Pariah Capitalism (referring to a trend for concentration on short-term materialistic benefit) in society. Tax revenues obtained from the gambling industry are spent for regional development

and provision of support for the less-privileged. However, an attempt to increase the government's revenue through the gambling industry cannot be justified. In his book, Max Weber cautions against lavishness and vanity, saying that they go against the spirit of capitalism which regards diligence and frugality as virtues²³). If people really wish to see the nation join the ranks of more industrialized countries, they should be willing to work harder and expect to get paid in return, thus establishing the sound spirit of capitalism.

Establishment of humanism-based values : It is also necessary to establish values stressing humanism-based capitalism supported by the free market principle, which emerges as a neo-capitalism, in an effort to overcome the morally corrupt materialism and cope with the advent of the knowledge-based society.

Establishment of creative spirit of challenge : Creative spirit of challenge should be fostered in the society, alongside with the adoption of humanism-based capitalism as a new strategy for economic development. Dynamic spirit of reconciliation is also required to overcome conflicts and confrontation between different regions and generations/classes of people and to mobilize all available resources for the goals of economic development.

23) Max Weber, *The Protestant Ethic and the Spirit of Capitalism*, Talcott Parsons, trans. New York: Charles Scribner's. 1958.

Appendix

Prospects for Major Macroeconomic
Indicators in 2007

< Prospects for Major Macroeconomic Indicators in 2007 >

		2005(P)	2006(E)	2007(E)		
Inter-national indicators (IMF)	World Economic Growth Rate (percent)	4.7	5.1	4.9		
	U.S. (China)	3.2 (10.2)	3.4 (10.0)	2.9 (10.0)		
	Japan (E.U.)	2.6 (1.3)	2.7 (2.4)	2.1 (2.0)		
Domestic Indicators	National Account	Economic growth rate (percent)	4.0	4.8	4.2	
		Final consumption expenditure (percent)	3.4	4.2	3.7	
		Private consumption (percent)	3.2	4.1	3.5	
		Gross fixed capital formation (percent)	2.3	2.9	2.5	
		Construction investment (percent)	0.4	0.5	1.5	
		Facility investment (percent)	5.1	7.5	4.5	
	Foreign Trade	Current account balance (\$ billion)	166	30	-30	
		Based on customs clearance	Trade balance (\$ billion)	232	170	100
			Exports (\$ billion)	2,844	3,250	3,550
			Growth rate (percent)	(12.0)	(14.3)	(9.2)
			Imports (\$ billion)	2,612	3,080	3,450
	Growth rate (percent)	(16.4)	(17.9)	(12.0)		
	Others	Consumer price (Average, percent)	2.7	2.5	2.8	
		Unemployment rate (percent)	3.7	3.5	3.7	
	Finance	Won-dollar exchange rate (Average, won/dollar)	1,024	955	925	
Government bond interest rate (Average, percent)		4.3	4.6	4.4		