

## Candlelight Vigil – Impact on Korean Construction Sector

July 2008 - Author: Kyung-Rae (K.R) Min, Senior Research Analyst

### MBnomics

**Backed by landslide victories in two elections – Presidential in December '07 and National Assembly in April '08 – the so called MBnomics (initiated by the President, Lee Myung-Bak) was born. It seems to have been greatly supported by the Korean public at the beginning, but it is massively overwhelmed by the candle lit vigils these days, losing the opportunity of contribution to GDP growth.**

MBnomics is characterised as “747: targeting 7% GDP growth, \$40K GDP per capita, and 7<sup>th</sup> largest economy in the world”.

The agenda of MBnomics include, among other things:

- 👑 tax cuts – corporate, individual, and real estate tax.
- 👑 deregulations on large conglomerates, change of ownership structures in financial/non-financial sectors and more market-friendly construction policies.
- 👑 privatisation of government-owned companies, (50 - 60 companies) including KEPCO (electric power company) and KoGas (Korean Gas Corporation).

Through these policies, the new Government intended to step up the Korean economy to more advanced status. However, within five months, MBnomics started to fall apart, with accusations that it's only focusing on benefiting wealthy people and high-income classes, disregarding people with low incomes.

Candle lit vigils started after the agreement made between Korea and the US in April during the Korean President's visit to the States and have continued for almost three months. Severe and long protests by the public against the import of US beef have limited Government's policy tools; MBnomics methods are viewed as something against the middle as well as the low-income class. Dissent from MB Government and MBnomics is shaped in the form of candle lit vigils and demonstration on the street.

### Impact on Construction Sector

One of the hardest hits is delay or lack of efficient deregulation in the construction sector. One typical example is the nullification of the Grand Canal projects, regardless of the necessity of the canals across the nation, the real benefit would have been undoubtedly on large construction companies. However, this opportunity has now been lost. Other deregulations that were expected from the commencement of MB Lee Government are:

- 👑 lowering withholding tax (including comprehensive real estate holding tax)
- 👑 more approval on re-development and re-construction works in greater Seoul area

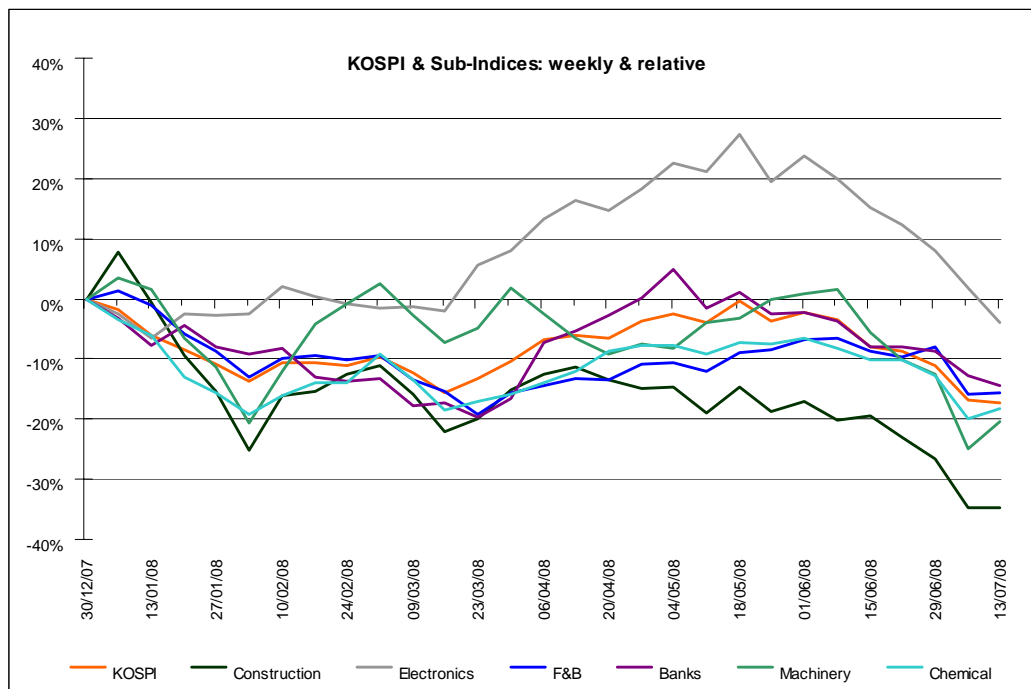
- 👑 easing financing restrictions (enhancement of loan to value hurdle for housing mortgage and more flexible credit provision)
- 👑 abolishment of “price cap system – ceiling of unit price” that causes lower profitability of construction companies.

The problem is that most of the fore-mentioned policies have significant potential to increase real estate prices, which is against the general public’s wish. An increase in real estate prices will induce severer political resistance by middle/low income classes. Basically, MBnomics is now in a dilemma. Without the US beef import issue, and without candle lit vigils on the street, MBnomics could have enforced more market-friendly policies to boost the construction sector, ultimately resulting in GDP growth. However, unfortunately, this chance has been lost, at least for the time being.

To make matters worse, most exogenous economic variables outside Korea are getting worse; strong crude oil price, financial turmoil from the US, and possibly lengthy slowdown in the US and the EU market, are bringing fear of high inflation, credit crunch and deteriorated trade deficit – inducing weaker KRW, thus higher inflation in a vicious circle.

The biggest victim has been, therefore, the construction sector (as shown in the graph), due to disappointment at lack of deregulation as well as more expensive financing costs. The number of unsold apartments keeps increasing (more than 130K units) and many small and medium construction companies are said to be faced with bankruptcies.

As of July 13, the YTD market index (KOSPI) was down by 17.4% and this contrasts with the construction sector index down 34.8% in the same period.



Source: Bloomberg

### More turbulence ahead?

Approval of US beef import is a pre-requisite condition for the ratification of the FTA (Fair Trade Agreement) between Korea and the US. The FTA will have a significantly positive impact on economic development. The first step is messy, mainly due to political reasons, and it retards economic growth now, not by delaying ratification of FTA, but by allowing less and less efficient economic policies by the Korean Government. We don't have proper and efficient monetary and fiscal policies now, and it seems to me that this will continue for the time being.

One of the articles in a Korean newspaper said the other day that the cabin crew of "747" don't have much experience of steering the plane, and, furthermore, the weather condition outside are stormy.

Unfortunately, the turbulence is likely to persist for the time being.