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Three Risk Factors of Corporate Investment in 2007

By JUNG Hyung-Min

1. Recent investment trends

In 2006, investment in plants and equipment has noticeably increased. Through the first three quarters of 2006, investment rose 8.1% from the same period last year driven by investment in services such as retail, transportation and logistics. In the first quarter of 2006, corporate investment in transportation and warehouses surged 25.7%. In the second half of the year, robust exports drove increased manufacturing in IT and petrochemical goods, boosting investment. Machinery investments, which account for a large portion of manufacturing investments, rose 9.7% and 11.9% in the second and third quarter, respectively. Machinery orders in the manufacturing sector also achieved roughly 30% growth during these two-quarter periods.

2. Three risks

Amidst these positive trends, however, doubt still remains over investment’s long-term trajectory. Indeed, numerous risk factors could drag down corporate investment. The first and main risk is reduced demand in mature consumer markets. The global economy is tapped to slow down this year which could have knock-on effects for Korea’s economy. Korea’s economy is projected to grow 4.3% in 2007, slowing from 4.8% growth in 2006. A slower global economy will likely constrain Korea’s exports and corresponding investments in the manufacturing sector.

Recent statistics illustrate that Korea’s exports to emerging markets (e.g., Latin America, the Middle East and ASEAN) are expanding, whereas exports to industrialized economies (e.g. the US, the EU and Japan) are decelerating. Goods exported to emerging markets are mostly low priced or can be manufactured through existing production facilities, making new investments less likely.

Meanwhile, private-sector consumption growth will likely to slow in 2007 to 3.7% year on year. This number is down from 4.1% in 2006 as households will likely reduce spending due to increasing debt obligations and weakening consumer sentiment ahead of the presidential election. As a result, corporate investment in services, a key domestic
demand-driven industry, will also likely slow down.

The second main risk is a strengthening Won. The Won is forecast around an average of 925 Won per US dollar in 2007, strengthening from a 955 Won per US dollar average in 2006. The Won’s rising value hurts manufacturers’ profitability. Manufacturing companies’ operating profit-to-sales ratio stood at 6.1% in both 2005 and the first half of 2006, down 1.5 percentage points from 2004 levels. The ratio dropped to 6% in the third quarter of 2006. Declining corporate profitability will strain available cash flow further limiting future investments.

### Operating Profit-to-Sales Ratio and Equipment Growth Rate of Manufacturers

The third main risk is social and political instability. Korea’s economy in 2007 faces numerous risk factors such as housing market instability, North Korea’s nuclear threat and upcoming presidential elections. Concerns are mounting that the Korean economy could be severely damaged by a sudden downturn in property prices. In addition, a contentious presidential election could impair the economy through inconsistent or self-serving policy-making. Firms are generally more passive in making investments during the time of presidential election. Indeed, investment faces greater volatility than production and consumption do, and is very much affected by economic sentiment. The nuclear issue may also have adverse effect on investment activities.
3. Outlook

In sum, equipment investment will likely slow to around 6% in 2007. A global economic slowdown, higher Won and economic uncertainty will all weigh down investment sentiment. As both exports and consumption slow, manufacturing and service investments will decelerate despite the expected recovery of the global economy and IT industry in the second half of the year. Exports will remain strong, but they will feel pressure as the foreign exchange rate approaches the breakeven point for Korea's exporters.

The government needs to maintain consistency to avoid confusion and exacerbate labor disputes. The policy focus should be on creating a corporate-friendly environment. These policies would include deregulating corporate investment, allowing factory construction in the Seoul metropolitan area and easing regulations on the current cross-shareholding restrictions among conglomerate affiliates. All this is necessary to boost companies' investments and enable them to make inroads into new industrial areas. In addition, unequivocal policy stance should be maintained regarding unlawful work stoppages to avoid hostile labor-management relations.

On the corporate front, companies need to pursue new strategies to turn crisis into opportunity. Firms should accelerate technology development and innovation to battle a strengthening Won, while aggressively investing in new products and processes. In the mid- to long-term perspective, it is crucial to upgrade technological capability and competitive advantage in sectors with razor-thin profit margins. Firms should focus on technology and materials industry development, as well as fostering of promising service industries.

The writer is a research fellow at the Macroeconomy Department Department, Samsung Economic Research Institute. Inquiries on this article should be addressed to hyungmin.jung@samsung.com.
Financial Market Trends (January 22 - 26)

Money and Bond Market

Interest rates rose sharply over the week. The three-year government bond yield surged to 5.06%, surpassing the previous high of 5.04% recorded in June 2006. The AA-corporate bond yield fell 1 basis point to 5.42%.

Contradictory to expectations, volatility has continued in the short-term funds market despite the Bank of Korea’s (BOK) decision to raise the cash reserve ratio hike in December. Meanwhile, President Roh’s comments on January 24 that the government had failed to control excess liquidity gave rise to concerns that the BOK will continue to tighten monetary policy.

Favorable economic data releases in the US scaled back market expectations for an interest rate cut by the Federal Reserve in 2007. Indeed, the prospect of an interest rate hike drove the ten-year US Treasury note yield to 4.8%, also helping push up interest rates in Korea.

Interest rates will likely fall this week, as December’s industrial output statistics may show a slowing domestic economy.

![Interest Rates Graph]

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**Equity Market**

Domestic stocks weakened throughout the week. The KOSPI edged up only 0.8% to 1,371.3, while the KOSDAQ Index fell 0.1% to 583.2.

The market’s downward movement was primarily driven by external factors. Weak fourth quarter earning results in the US drove a downturn in equity markets abroad. In addition, foreign investors were net sellers over the week in the futures market to the tune of 58.3 billion Won.

Investor sentiment this week will largely depend on the release of key economic indicators for December in industrial output, consumption and investment. The performance of foreign stock markets will also influence the domestic bourse’s trajectory.

**KOSPI & KOSDAQ**

![Chart showing stock market performance]

**Foreign Exchange Market**

The Korean Won weakened over the week with the Won-dollar exchange rate closing at 940.5 Won per US dollar, up 4.2 Won from the previous week.

Weaker than expected inflation numbers released January 26 in Japan means that the BOJ will likely further delay an interest rate hike during its February meeting. The BOJ, which traditionally uses inflation as a main consideration in adjusting interest rates,
might pause further keeping the carry trade intact and the Yen at record low levels.

Meanwhile, the Korean government said it will implement a ‘smoothing operation’ for the currency market increasing the likelihood of government intervention. Finally, the US dollar remained strong helped by rising domestic and foreign demand for US goods.

The Won will continue to weaken as Japan’s anticipated rate hike is delayed, and positive US economic data continues to prop up the greenback.

**Foreign Exchange Rates**
The Age of Web 2.0

By KWON Ki-Duk

I. Advent of the Web 2.0 Era

Of late, Web 2.0 has drawn worldwide attention. Web 2.0 means “an open Internet where users proactively participate in producing, sharing, and consuming knowledge and information.” In the era of Web 2.0, Internet users interact with each other on an “open platform” through which anyone can create and consume content. Search engines such as Google and Naver work as the basic platform promoting knowledge creation and sharing. Social networking sites, including MySpace and Cyworld, also play a key role as a platform serving such purpose. As public attention has shifted from text-based content to photo and video contents on the web, photo sharing website Flickr and video sharing site YouTube have also emerged as major platforms.

On open platforms, Internet users can either post their own texts, photos and videos, or relay knowledge and contents created by others to other websites. Web 2.0 has enabled general Internet users to create their own contents, thus further diversifying the information available on the web and accelerating the pace of information distribution.

There are key factors that have driven Web 2.0’s creation. The proliferation of technology and multimedia devices is one main factor. As devices such as mobile phones, cameras, and camcorders have been widely used, ordinary Internet users can create rich multimedia contents at a relatively low cost. Development of Internet technologies and high uptake of broadband have also contributed to the rise of Web 2.0. Widespread use of the Internet is another factor. Today’s people, especially young Internet users, have a strong desire to lead digital culture and create new trends. Last, Internet businesses have developed innovative business models and services, encouraging Internet users to create and share contents.

II. Changes Driven by Web 2.0

1. Value creation

Web 2.0 has brought about numerous changes in the economic value chain. Its influence
is not merely limited to the Internet; it also affects the national economy, industry, society, and corporate management. Web 2.0 has promoted web activities to the general public, thus increasing diversity on the web. An increase in the diversity and quantity of information has accelerated the pace of information distribution, which in turn has encouraged Internet users to recreate the circulated information.

2. Increased diversity

Consumers often have difficulties gaining information on niche products from mass media. Web 2.0 has solved this problem by allowing people to exchange information on niche products, thus enabling niche markets to grow. It also makes way for niche products, which are not typically offered by established offline retailers, to reach consumers. For example, 25% of Internet bookseller Amazon’s sales come from niche books which are not sold by offline bookstores. Similarly, 21% of DVD rental website Netflix’s sales originate from films that cannot be found in offline video rental shops.

Web 2.0 also gives business opportunities to small businesses to promote their products and services. In the brick-and-mortar world, small companies cannot afford large-scale marketing efforts due to prohibitive promotion and distribution costs. In the era of Web 2.0, however, small companies and those self-employed can reach potential consumers at much lower cost than before. Keyword advertisement and pay-per-click advertisement can be good promotion strategies for small companies.

On the social and political front, Web 2.0 has let minority opinions be heard and injected greater diversity into culture. In the past, a few politicians and established media outlets dominated political discourse. Not anymore. Web 2.0 allows politicians and constituents to interact better with each other. In Korea, user created content (UCC) will play a critical role in the upcoming presidential election slated for December 2007. For example, presidential candidates will effectively leverage cyberspace where they can release their schedule and their supporters can upload their own opinions and newly created contents.

3. Changes in value chain

Web 2.0 has also brought about substantial changes in numerous industries. In the media industry, the number of content producers has increased and diversified.
Currently, citizen media producers have expressed their opinions and created their own contents through blog activities. UCC’s popularity is evidenced by the fact that Korean B-boy crew Expression’s performance in New York is estimated to be seen by more than 10 million viewers after being posted on the web.

In the publishing business, traditional way of producing and distributing information is changing. As consumers proactively participate in knowledge creation, knowledge becomes a public good. In addition, as the life cycle of knowledge-related products is getting shorter, offline distribution channels cannot catch up with the rapid release of new knowledge, thus giving more way to online knowledge distribution channels.

Information technology firms have transformed their business models from computer-based one to web-based service model. Google and Microsoft have introduced fee-based services, instead of solely depending on packaged software sales. The telecommunications industry has promoted greater synergy by combining exiting services and Web 2.0. Korea’s wireless telecom service providers enable mobile phone users to access to UCCs about location of restaurants and transportation information.

4. Corporate management

In the wake Web 2.0’s emergence, corporate management has faced four changes:

First, more businesses have tapped outside resources in the process of idea generation and technology development. This phenomenon is called “crowd-sourcing.” Currently, companies belonging to home appliances, automobile, insurance, fast-food and toy industries have reflected consumers’ opinions into their product development. Record labels, TV stations, and movie producers either pick out potential stars or get fresh ideas by watching UCCs uploaded by the general public.

Second, Web 2.0 creates new business opportunities. Recently, technology firms have released the latest products such as mobile phones equipped with built-in video cameras and affordable camcorders so as to help consumers to create their own contents and post them on the web. Service firms also well take advantage of Web 2.0 in their businesses. For example, real estate agency HousingMaps.com lets its users find houses and apartments through maps and satellite photos provided by search engine Google.
Third, online communities have become the center for buzz marketing, a powerful marketing tool for films and television programs. Two Korean films “The Host,” and “The King and the Clown” smashed all previous box-office records as a result of successful buzz marketing via online communities. Bloggers also play a key role in buzz marketing. Hybrid marketing using both online and offline approaches has also become a powerful marketing tool.

Fourth, new business models will appear. A conventional company is usually comprised of an employer and lots of employees. In a networked world, however, lots of individuals participate in business activities and generate profits, thus forming a so-called “collective enterprise.” The US’ auction site eBay and online encyclopedia Wikipedia are prime examples of this sort. Operators of collective enterprises should give “reputation capital” to users who provide trustworthy knowledge or products.

III. Suggestions

With the advent of Web 2.0, companies need to develop new business models and innovate their management practices, instead of ignoring developments on the Internet. Most of all, they should accept consumer ideas regarding product development. At the same time, they need to improve existing product lines and transform current business models to satisfy consumer demand. Also, they must keep abreast of rapidly changing consumer demands and set up segmented marketing strategies targeting niche markets.

Finally, they should recognize that Web 2.0 cuts both ways. On one hand, it creates new business opportunities. On the other hand, it poses acute risks to established businesses. Currently, any consumer can post her opinion on the web, which may spread fast. If a consumer has good impression on a product or service, her comments can be an asset to corporate activities. However, if one uploads negative opinion on a product or service, she can deal a serious blow to the company. Against this backdrop, companies need to make more efforts to provide quality products and services to satisfy fickle consumers.

The writer is a research associate at the Technology & Industry Department, Samsung Economic Research Institute. Inquiries on this article should be addressed to kdkwon@seri.org.