

KOREA

Overview

1. After decelerating through much of 2004, growth in Korea accelerated through the course of 2005, supported by both external and domestic demand. Growth picked up from a year on year pace of 2.7 percent in the first quarter to 5.2 percent in the fourth. Growth was particularly strong in the third and fourth quarters, reaching quarter on quarter annualized rates of 7-8 percent, led by a sharp rebound in exports, reflecting renewed strength in global demand for IT-related products. Private consumption also strengthened through the year, after more than two years of decline or stagnation. The recovery in consumption and global electronics demand has filtered into corporate sector activity, resulting in a surge in facilities investments and a pickup in hiring in the final quarter. Balance sheets of corporations and financial institutions have continued to improve. On the policy front, the central bank commenced monetary tightening last October. The government has also shifted its fiscal policy stance from proactive to neutral for this year. As near-term economic conditions have improved, a greater focus of economic policy has been on longer term issues, including income disparity and the rapid aging of society.

Figure 1. Real GDP and expenditures
(Index 2001 Q1 = 1.00)

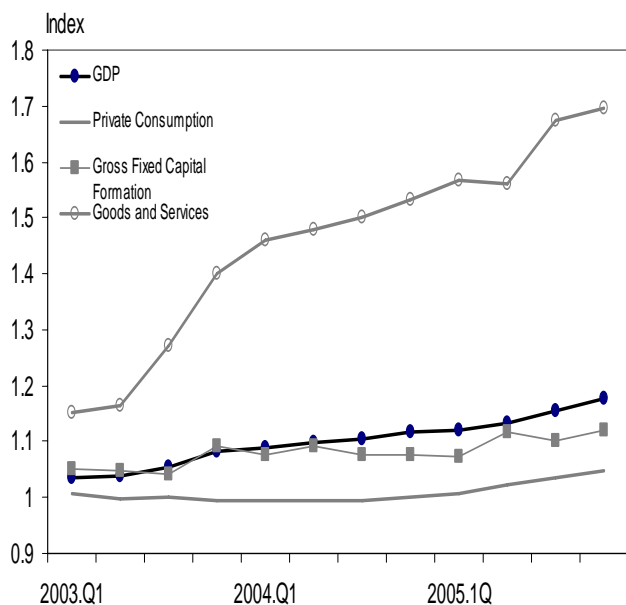
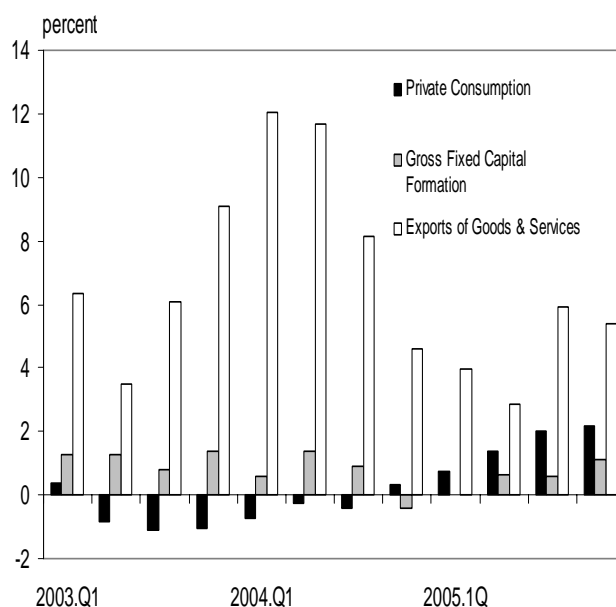


Figure 2. Contribution to year-on-year growth in final demand (percent)



Recent Macroeconomic Developments

Output, employment and inflation

2. Export growth on a national account basis rebounded strongly to an 11.1 percent year-on-year growth rate in the latter half of 2005, compared to 5.5 percent in the second quarter, reflecting recovery in global demand for IT-related products. On a customs clearance basis, exports to the U.S., the major export destination of IT-related products, declined by 4.7 percent over the previous year in the latter half, less than a decline of 12.7 percent in the second quarter. Meanwhile, exports to China, the Korea's largest export market since 2003, continued to exhibit a double-digit growth of about 25 percent during the latter half of 2005. Exports to Japan also continued to grow by about 10 percent over the year during the same period. However, exports of textiles decreased substantially, due to the removal of export quotas on textiles at beginning of last year, as a result of the ending of the international Agreement on Textiles and Clothing. This has put substantial pressures to small and

medium sized enterprises (SMEs). Exports of light industry declined by about 10 percent over the previous year in 2005.

3. Given the continued economic expansion in the industrialized countries, including a robust recovery in Japan, as well as high economic growth in China, exports are likely to grow steadily in 2006. Nevertheless, the strengthening of won, which appreciated by about 7 percent in the past six months (returning to pre-1997 financial crisis levels) could pose a downside risk to the country's exports. The effect of the stronger won may have yet to materialize, however, as exports on a customs clearance basis continued to grow by over 10 percent in the first two months of 2006. The stronger won is particularly problematic for SMEs, which cannot afford to use hedging instruments against foreign exchange fluctuations. The recovery of exports heavily depends on sustainability of electronics demand, as these products account for 40 percent of the country's exports.

4. Private consumption strengthened throughout 2005, after more than two years of decline or stagnation when consumers were trying to pay down excessive household debt. Stronger consumption growth was supported by improvements in labor market conditions and the positive wealth effect of the higher stock prices. On a national account basis, growth of private consumption accelerated from 2.8 percent from a year ago in the second quarter to 4.0 percent in the third quarter and further to 4.6 percent in the final quarter. The recovery of consumption has been accompanied by some rise in household debt, though net assets of the sector have grown due to higher stock prices, which rose by 50 percent last year. Credit card purchase surged by 18.1 percent over the previous year in the latter half of 2005.

5. Growth of private consumption is expected to pick up moderately in 2006, primarily due to strengthening labor market conditions. Government measures last year to curb excessive house price increases are unlikely to have a large impact on consumer spending. Planned increases in taxes on the household sector will be gradual,

as tax reforms to impose an ownership tax on real estate and to raise capital gains tax on real estate transactions are scheduled to be phased in step by step from the end of 2006. Any potential adverse wealth effect of curbs on real estate speculation are not expected to be large, given that government measures so far have not led to a decline in housing prices. Empirical work suggests that the wealth effect of housing in Korea is considerably less than that of stocks, in part because Korea's home ownership ratio is relatively low compared to those in other industrialized countries. Nonetheless, the household sector remains vulnerable to a significant reversal in economic conditions or sentiment, given the high level of the household debt to GDP ratio, which climbed again to around 63 percent at the end of 2005, substantially higher than 40 percent in 1999 when the credit card boom commenced.

6. Fixed investment strengthened somewhat in the final quarter of last year, due to a surge in facilities investment. On a national account basis, it grew by 3.7 percent over the previous year in the fourth quarter of 2005, compared to around 2.0 percent in the previous two quarters. High capacity utilization, increased profits of large companies, and improved business confidence resulted in a surge in facilities investment in the final quarter. Facilities investment rebounded from a 2.9 percent year-on-year growth rate in the second quarter to 4.3 percent in the third quarter and further to 9.8 percent in the final quarter. On the other hand, construction investment has been restrained by government measures to curb speculative transactions in real estate. Growth of construction investment slowed to 0.4 percent and 0.9 percent over year ago levels in the third and fourth quarter respectively, compared to 1.7 percent in the second quarter. On a quarter-on-quarter seasonally-adjusted basis, construction investment fell by an annualized 7.7 percent in the third quarter of 2005 and a further 2.2 percent in the fourth quarter.

7. Looking ahead, growth of fixed investment is expected to rise moderately in 2006, led by higher growth in facilities investment.

According to a survey by the Ministry of Commerce, Industry and Energy, the country's 200 biggest companies will increase facility investment by 16.1 percent over the previous year in 2006, compared to 14.2 percent in 2005. Given the ample liquidity in the hands of large companies and financial institutions, monetary tightening is unlikely decelerate growth of facilities investment. Meanwhile, construction investment is likely to increase marginally, with reduction of speculative housing investment largely offset by a rise in public housing investment and full implementation of the Comprehensive Investment Initiative (CII). The government is planning to increase housing investment particularly in the Seoul Metropolitan area in order to stabilize housing prices. In addition, the CII, which was originally planned to start in the second half of last year, is expected to be fully implemented this year.

8. The recovery of export and domestic demand has translated into a sharp rebound of industrial production. Growth of industrial production has risen sharply to a 7.2 percent year-on-year increase in the third quarter and further to 10.4 percent in the fourth quarter, compared to 3.5 percent in the second quarter. Stronger growth has filtered into the labor market since the end of 2005. The unemployment rate averaged 3.4 percent in the first two months of this year, down from around 3.6-3.8 percent for the last two years. However, production of manufacturing SMEs grew marginally by 1.9 percent in 2005, down from 3.8 percent in 2004.

9. Inflation has been subdued, in part due to the strengthening of the won. Core inflation rates came down to 1.7 percent in February 2006, well below the lower range of the Bank of Korea's medium term target of 2.5-3.5 percent. The Bank of Korea (BOK) projects that the economic recovery and persistent higher oil prices will drive up core inflation rate to 3.3 percent in the second half of this year, which is above the mid-point of its target range. The BOK also project that headline inflation will rise to 3.4 percent in the second half of this year, in part due to rise in

public services charges such as public transport fares, as well as higher cigarette taxes.

10. Housing prices have been rebounding moderately since last November, after the government measures had stabilized the real estate market between August and October. Housing prices in the Seoul Metropolitan area have risen for seven consecutive years through 2005. In the *Gangnam* area, where speculative transactions have been the most evident, housing prices rose by about 12 percent in the second half of last year. The widening wealth and income disparities resulting from booming real estate prices as well as rising dualism between regular and irregular workers in the labor market, have become one of the top economic policy issues in Korea.

External Sector

Current account developments

11. The current account surplus in 2005 decreased substantially by US\$ 11.6 billion or 41.2 percent over the previous year to US\$ 16.6 billion (around 2 percent of GDP) from US\$ 28.2 (4.1 percent of GDP) in 2004, due to a combination of three factors. First, the trade surplus narrowed by US\$ 4.1 billion over the previous year to US\$ 33.5 billion, as imports rose by 16.1 percent, compared to a rise in exports of 12.1 percent. This out-performance of imports is attributed to higher prices of crude oil and other raw materials. The unit value of imports rose by 9.4 percent in 2005, compared to a marginal rise of the unit value of exports by 1.5 percent, which resulted in a continued deterioration of terms of trade (On the other hand, export volumes grew at a faster pace of 9.1 percent compared to import volume growth at 6.2 percent, reflecting weak domestic demand in the first half of the year). Secondly and more importantly, the services account deficit widened substantially by US\$ 5.0 billion to US\$ 13.1 billion in 2005 compared to a year earlier, as overseas travel by Koreans jumped as a result of won appreciation. Thirdly, the income account shifted to a deficit of US\$ 1.3 billion in 2005 for the first time since 2002,

compared with a surplus of US\$ 1.1 billion in the previous year, with increase of interest income more than offset by increase of dividend payments abroad.

Figure 3. Exports and imports of goods (US\$ billion)

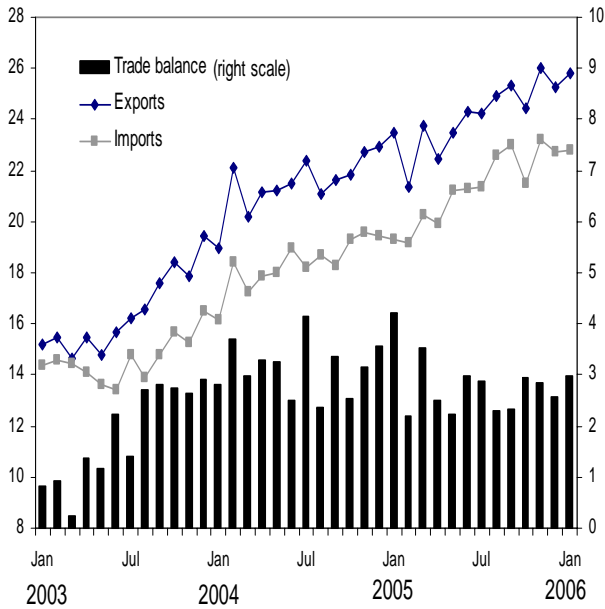
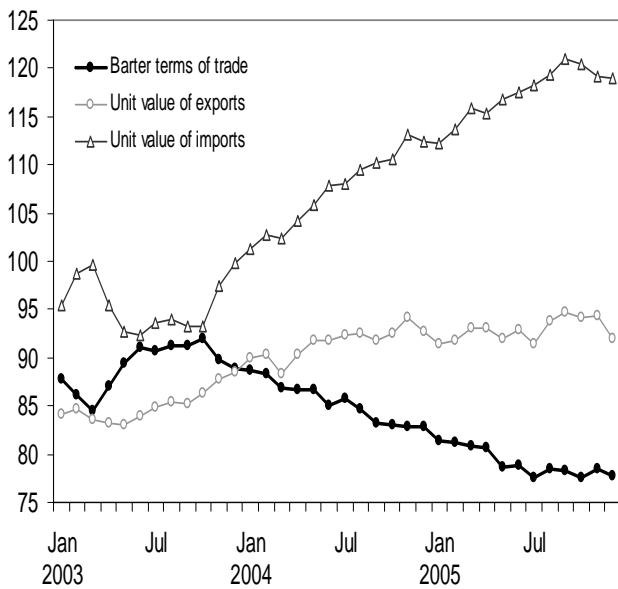


Figure 4. Trade indices



Capital account developments

12. The capital account surplus also diminished significantly to US\$ 0.5 billion in 2005 from US\$ 7.6 billion in 2004, in large part due to a shift to deficit in the portfolio investment account. Portfolio investment registered a net outflow of US\$ 1.3 billion in 2005 for the first time since 1999, compared to a large inflow of US\$ 8.6 billion in 2004. The capital outflow was attributed largely to a drop of stock investment by foreign investors against the background of the interest rate hikes in the U.S. As a result, the ratio of non-resident holdings of stocks declined to 39.7 percent at the end of 2005 from 42.0 percent at the end of 2004. In addition, portfolio investment abroad continues to increase, due to a widening of interest rate differentials.

13. The narrowing of the capital account surplus was complemented by a sharp decline of direct investment inflows. The direct investment account was almost balanced in 2005, compared to a surplus of US\$ 4.6 billion in the previous year. Foreign investment to Korea decreased by more than a half, compared to the previous year when Citigroup acquired KorAM Bank. Similarly, acquisitions of Korea Exchange Bank and LG Card, are expected to be major determinants of direct investment inflows for 2006. Meanwhile, foreign investment abroad continued to reach high levels, led by active investment in emerging Asia, against a background of continued strengthening of the won and rigidities in domestic labor market. Foreign direct investment in Asian countries, which accounted for 60 percent of the total, rose by 14 percent in 2005, while investment in North America and Europe was scaled down.

14. Investment other than direct investment and portfolio investment registered a net inflow of US\$ 4.1 billion, compared to a large net outflow of US\$ 3.9 billion a year ago, largely due to increase in banks' borrowing from overseas. Korean banks continued to see a downward trend in the spread of their borrowing rates against Libor; the Libor spread of 3-month borrowing narrowed to 8 basis points in the second half of 2005, compared to 11 basis points in the first half.

Foreign exchange reserve management

15. Continued surpluses on both the current and capital accounts continue to increase the country's foreign exchange reserves, which rose by US\$ 19.8 billion in 2005. As of the end of February 2006, foreign exchange reserves stood at US\$ 215.9 billion, which is about 10 months of imports and almost 3 times Korea's short term debt outstanding. The strong external position was further strengthened by regional financial cooperation activity, as Korea and Japan concluded a two-way bilateral swap arrangement to upgrade the Chiang Mai Initiative in February. The two countries made an arrangement under which Japan would swap up to US\$ 10 billion for won while Korea would swap up to US\$ 5 billion for yen in the event of a crisis, which replaced the former one-way swap arrangement under which Japan would provide US\$ 7 billion to Korea.

16. With ample foreign exchange reserves, the government launched the Korea Investment Corporation (KIC) in July last year to invest an initial amount of US\$ 20 billion of foreign exchange reserves in foreign bonds and stocks. The KIC is expected to help develop the country's asset management industry, which will promote the country as a regional financial hub and deal with the rapid aging of society. The corporation has started to sign a memorandum of understanding with the industry to entrust its funds in the latter half of last year. In addition, the government made an announcement to relax regulations on capital outflows in order to mitigate the chronic over-supply of dollars in the foreign exchange market in March. The position limit for banks will also be relaxed to deepen the foreign exchange market; the limit is raised to 30 percent of total equity capital of banks from 20 percent.

Monetary and fiscal developments

17. The Bank of Korea (BOK) commenced monetary tightening last October when it raised its target for the benchmark call rate

(uncollateralized call rate) from 3.25 percent to 3.5 percent, in response to latent inflationary pressures from the economic recovery and higher oil prices, as well as the rebound of real estate prices. The BOK continued to raise its target by 25 basis points in December and February, sending the rate to 4.0 percent, which is the level of mid-2003.

18. Given the deepening economic recovery, the government has no plan to frontload public expenditure in the first half of 2006, as occurred in 2005. Spending for redistributive and social welfare functions to help those on lower incomes gain access to loans to buy homes will increase substantially, increasing overall spending on the general account by about 7-8 percent over the initial budget for 2005. As tax revenue is expected to grow in line with the economic expansion, the fiscal balance including the social security fund will continue to be in a surplus of somewhat under 1 percent of GDP in 2006.

19. In the long-term, however, the rapid pace of population aging will place significant pressures on the National Pension Scheme (NPS), which commenced in 1998. Fundamental reforms in terms of replacement and contribution rates will be needed to ensure sustainability of the system, while providing adequate coverage. In order to supplement NPS, the government has introduced the Corporate Pension Scheme since the end of 2005, which amounted to Won 22.1 billion as of January 2006.

Financial and Corporate Sector Developments

The performance of the banking sector

20. Korea's domestic banks have continued to strengthen their financial position. The average non-performing loan ratio of the banks fell to 1.2 percent at the end of 2005 from 1.9 percent at the end of 2004. The non-performing loan ratio hit record lows for all categories of loans: the non-performing ratios for corporate loans, household loans, and credit card receivables declined to 1.3 percent, 1.0 percent, and 2.4 percent, respectively. As a result of increased net income, the average

capital adequacy ratio rose to a record 13.0 percent at the end of 2005 from 12.1 percent at the end of 2004. All of the banks reported capital adequacy ratios higher than 10 percent at the year's end. A drop in provisioning for non-performing loans and a sharp increase in non-operating income from securities investment gains drove up banks' net income in 2005 by 52.4 percent over the previous year, to a record high of Won 13.4 trillion.

The performance of the non-bank sector

21. The six credit card companies have been improving in financial health. They recorded a combined profit of Won 339.3 billion in 2005 for the first time in three years, thanks to a rise in credit card purchases and a decline in the delinquency ratio. The average credit card delinquency ratio declined to 10.1 percent at the end of 2005, down from 18.3 percent at the end of 2004. The average capital adequacy ratio rose sharply to 19.0 percent at the end of 2005 from 9.8 percent at the end of 2004, as a result of higher profits, an equity investment by GE Consumer Finance in Hyundai Card and a capital increase by Samsung Card. Meanwhile, net income of domestic securities companies rose sharply to Won 2.62 trillion in the first three quarters of fiscal year 2005 ending December, from Won 251.0 billion a year earlier. A jump in commission income from brokerage services and from the sale of equity-linked securities, and interest income contributed to the significant improvement of the net income.

Restructuring and re-capitalization of financial institutions

22. The year 2006 is expected to see further consolidation of commercial banks and rising participation of foreign banks in the sector. Shinhan Bank and Chohung Bank are scheduled to merge in April, which makes Shinhan Bank the second largest bank after the Kookmin Bank. Meanwhile, Lone Star Funds, the U.S.-based private equity fund is set to sell Korea Exchange Bank, as both domestic and foreign banks have shown great interest in acquiring the bank.

23. Large Korean commercial banks are moving into the universal banking business by setting up financial holding companies or acquiring non-bank financial institutions. Hana, the fourth largest bank, was reorganized into a financial holding company at the end of 2005, following Woori Financial Group and Shinhan Financial Group, which hold the second and third largest banks in the country. Since the aftermath of the financial crisis, there has been a growing awareness that the commercial banks should diversify their income sources to make them less vulnerable to business cycles. Abundant cash in the hands of large companies and a low interest environment have also given incentives for the commercial banks to move into non-banking businesses.

24. In addition, Korea's government plans to submit a bill to bring down walls dividing non-banking businesses in the second half of 2006, in order to expedite the trend of universal banking, as well as to promote the country as a regional financial hub. The Capital Market Consolidated Act will allow financial institutions to conduct a variety of non-banking businesses including securities business, investment banking, asset management, and trusts. Besides, the government is considering allowing foreign companies to establish financial holding companies.

25. Meanwhile, creditor banks of LG card are also set to sell their stakes to investors, after the credit card issuer recorded a record high profit last year. Domestic financial holding groups have expressed their strong interest in purchasing the company in order to diversify their income sources, and foreign financial institutions are also keen on the acquisition.

Developments in the capital markets

26. Reflecting ample liquidity in the hands of large companies, domestic companies scaled down their fund raising through publicly offered debt and equity by 6.5 percent to Won 54.8 trillion in 2005. In spite of surging stock prices, equity financing totaled Won 6.7 trillion, marking

a sharp decrease of 18.7 percent from a year earlier. While SMEs increased equity financing by nearly 70 percent, large companies reduced fund raising in the stock market by over 40 percent. Similarly, corporate bond issuance (excluding asset-backed securities and financial bonds) declined by 15.5 percent over the previous year to Won 22.2 trillion in 2005, partly due to rise in bond yields; corporate bond yields picked up from 3.7 at the end of 2004 to 5.5 percent at the end of 2005.

27. On the other hand, issuance of financial bonds and asset-backed securities (ABS) increased in 2005, chiefly because of a surge in debt issuance by credit card companies. Financial companies increased bond issuance by 14.3 percent over the previous year to Won 9.1 trillion, and ABS issuance also increased by 3.9 percent from a year earlier, totaling Won 16.8 trillion. In addition, Korea's mortgage-backed securities (MBS) market has been expanding steadily. Korea Housing Finance Corporation (KHFC) -- a newly created mortgage finance entity in 2004 -- sold mortgage loans of Won 4.2 trillion in 2005, compared to Won 3.3 trillion in 2004.

Corporate sector developments

28. In general, Korea's corporate sector remains healthy, though SMEs are still saddled with excessive debts. While over 2,500 SMEs have entered private debt workouts since they were introduced in July 2004, about 75 percent of them are still under the workout process. Though the delinquency ratio for bank loans to the sector declined to 1.6 percent at the end of 2005 from 2.1 percent at the end of 2004, it was attributed partly to guarantees by the government credit guarantee agencies. The government plans to announce a comprehensive measure to tackle structural problems in SMEs this year.

Macroeconomic outlook

29. A moderate acceleration of both consumption and investment is expected to result in overall GDP growth of 5.0 percent in 2006, compared to 4.0 percent in 2005. External shocks

including the strengthening of won, persistently high oil prices and reversal of demand for IT-related products could pose a substantial downside risk to the highly open economy. In addition, SMEs and household sector remain vulnerable to these shocks, as they are still highly indebted. On the other hand, with favorable external conditions, improved business confidence could result in a sharp rise of corporate spending, supported by the strengthened financial position of large firms and banks.