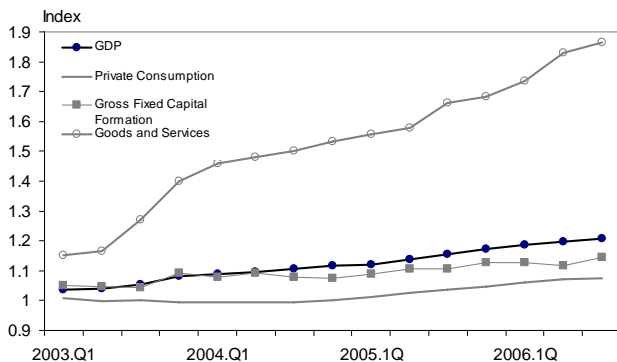


# KOREA

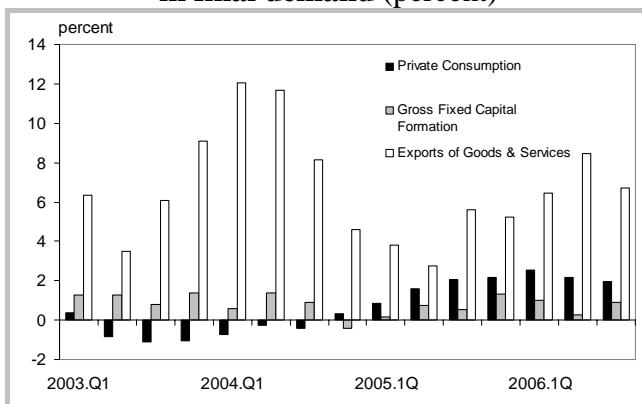
## Overview

1. After accelerating throughout the course of 2005, Korea's economy slowed down this year, principally due to weaker domestic demand. Real GDP growth moderated to a 4.6 percent year-on-year pace in the third quarter of 2006 from 6.1 percent in the first. Inflation has continued subdued, aided by the strengthening of won, although real estate prices have been on a sharp rise recently. On the policy front, the central bank has kept policy interest rates steady for the past two months after having tightened monetary policy since last October, while on fiscal policy the government maintains a broadly neutral fiscal stance. Going forward, it remains to be seen to what extent North Korea's recent nuclear test will affect consumer and business confidence.

**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. Exports have been performing well despite a sharp appreciation of the won over the past several years. On a national accounts basis, exports exhibited double-digit year-on-year growth in the first three quarters of 2006. The sizeable appreciation of the won, which has risen by about 20 percent against the dollar over the last three years, has had a relatively limited impact on the export performance of large Korean companies, in large part due to significant productivity improvements and the high non-price competitiveness of Korean IT-products, though it has certainly squeezed these companies' profits to some extent. On a customs clearance basis, exports to the U.S., the major export destination of Korea's IT-related products, rebounded to about a 10 percent year-on-year increase in the second and third quarters from zero growth in the first quarter. Exports to China, Korea's largest overall export market since 2003, continued to exhibit double-digit growth. Going forward, export growth is likely to remain robust, though it will soften broadly in line with the expected slowdown in industrialized countries.

3. Consumer spending growth exceeded household income growth for the past two years, but has started to moderate since the second quarter of 2006, as consumer sentiment has deteriorated on the back of concerns about possible downside risks such as rising oil prices, higher interest rates, a U.S. economic downturn and tensions with North Korea. After strengthening during 2005, private consumption moderated from a 4.8 percent year-on-year increase in the first quarter of 2006 to 3.9 percent in the third quarter. On a seasonally-adjusted annualized quarter-on-quarter basis, the slowdown is more evident; consumption growth declined to 2.5 percent in the third quarter. Looking forward, on the positive side, the firm labor market should help limit the extent of the slowdown in consumption. On the other hand household debts

have continued to climb reaching a record high of 65 percent of GDP at the end of June 2006 from 62.0 percent a year earlier, which may constrain debt-burdened consumers going forward. Consumer borrowing has picked up as credit companies have returned to financial health and an competition among them has intensified. Banks have also shown more interest in providing mortgage loans against a background of a weak demand for funds by large companies with ample liquidity.

4. Meanwhile, investment remained sluggish, in part due to government measures to restrain speculative investment in real estate. Growth of fixed investment averaged 2.5 percent over the year for the first three quarters of 2006. While facilities investment grew by 8.0 percent, construction investment contracted by 1.7 percent during the period. Looking ahead, investment is likely to remain subdued, as the government policy package announced in August last year and the follow-up measures unveiled in March take effect. They include charges on developers and buyers for some of the costs of associated infrastructure, reconstruction development charges and a comprehensive real estate tax. In addition, facilities investment may also slow in response to recent deterioration in corporate profits and low business confidence. Listed companies saw a decline in profits of about 8 percent in the first half of 2006, as rising oil prices and the soaring value of the local currency squeezed margins.

5. Weaker domestic demand has translated into a moderation in industrial production. Growth of industrial production slowed to a 7.4 percent year-on-year increase during July and August from 12.1 percent and 11.0 percent during the first and second quarter, respectively. Strikes at local carmakers and heavy rainfall also contributed. Meanwhile, production growth at small and medium sized manufacturing enterprises (SMEs) further slowed down to 1.6 percent during the first half of this year from 1.9 percent in 2005, largely due to the stronger won.

6. Labor markets have been firm; the unemployment rate has been steady at around 3.5 percent during the first nine months of this year. However, employment growth is failing to generate many permanent jobs, due to high costs of hiring for companies. About 37 percent of salaried employees are now under fixed-term contracts, which is 10 percentage points higher than four years ago and 2.5 times the OECD average.

7. Inflation has continued subdued, aided by the strengthening of won. Core inflation remained at 2.2 percent for the four months to September, which is well below the lower range of the Bank of Korea's (BOK) medium term target of 2.5-3.5 percent. Headline inflation has also been subdued, averaging 2.4 percent during the third quarter. Given an expected moderation in economic growth and the recent decline in oil prices, inflation is likely to be kept in check though the next year.

8. On the other hand, housing prices have been rebounding strongly since last November, despite earlier restrictive government measures which had temporarily stabilized the real estate market previously. In Seoul housing prices rose by nearly 9 percent for the first nine months in 2006, compared to 2 percent in 2005. The *Gangnam* area where speculative transactions have been the most evident, saw a rise of about 17 percent during the period. The widening wealth gap resulting from booming real estate prices and the rising dualism between regular and irregular workers have been one of the top economic policy issues in Korea.

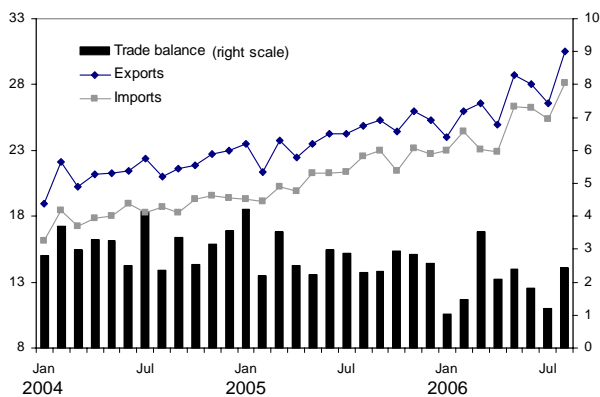
## ***External Sector***

### ***Current account developments***

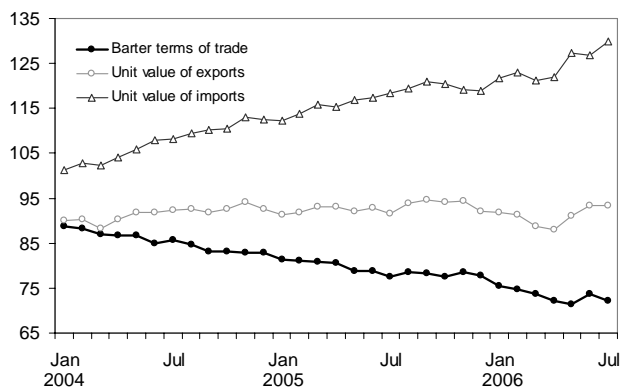
9. The current account slipped into a slight deficit of US\$ 1.3 billion in the first eight months of 2006, compared with a surplus of US\$ 9.4 billion a year earlier. First, the trade surplus substantially narrowed by US\$ 6.7 billion to US\$ 15.8 billion, due to a larger oil import bill. Imports rose by 20.6 percent, while exports rose

by 14.4 percent during the period. The unit value of imports rose by 7.7 percent during the first seven months of this year, compared to a slight decline of the unit value of exports, which resulted in a continued deterioration in the terms of trade. Deteriorating terms of trade more than offset the faster growth in export volumes - 13.9 percent - than in import volumes, at 10.8 percent. Secondly, the services account deficit widened substantially by US\$ 3.2 billion or 33.3 percent to US\$ 12.7 billion in the first eight months of this year compared to a year earlier, as overseas travel by Koreans jumped on the back of won appreciation. The BOK slashed its forecast for the full-year current account surplus to US\$ 4 billion, one quarter of its previous estimate.

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



**Figure 4. Trade indices**



### Capital account developments

10. The deterioration of the current account was more than offset by the widening of the capital account surplus in the first eight months of 2006. Other investment than direct investment and portfolio investment registered a large inflow of US\$ 13.2 billion, compared with an inflow of US\$ 4.4 billion a year ago, largely due to increase in banks' borrowing from overseas. As the creditworthiness of the country and banks has progressively strengthened, foreign banks have been increasing their exposure to Korean banks since 2002. The historically low interest rate on the Japanese yen has also given a strong incentive for SMEs to borrow the foreign currency. As a result, the country's short-term debts rose to a record level of US\$ 94.6 billion at the end of the second quarter, exceeding the previous peak in 1997. In response to the rising currency and interest rate risks facing retail customers, the authorities have instructed banks to adopt stricter requirements for yen-denominated lending.

11. The direct investment account registered a net outflow of US\$ 1.3 billion in the first eight months of 2005, compared with a inflow of US\$ 0.3 billion a year earlier. Foreign investment abroad surged by about 50 percent, led by investment in Asia, which accounts for nearly 60 percent of total foreign direct investment. In addition, portfolio investment registered a large net outflow of US\$ 20.9 billion, compared to a marginal outflow of US\$ 1.9 billion a year earlier. The net portfolio capital outflow was attributed to large sales of stocks by foreign investors during the worldwide correction in emerging equity markets in may-June 2006, as well as concerns over an economic slowdown and worse-than-expected earnings by exporters. Meanwhile, portfolio investment abroad continued to increase, partly due to rising U.S. interest rates. As of June 2006, the total foreign currency securities in the hands of Korean institutional investors increased from US\$ 35.6 billion at the end of 2005 to US\$ 44.2 billion at the end of June 2006. Among institutional investors, insurance companies held 46 percent of foreign currency denominated securities, while banks and asset management

companies held 23 percent and 24 percent, respectively.

#### *Foreign exchange reserve*

12. The surpluses on capital accounts continued to increase the country's foreign exchange reserves, which rose by US\$ 17.8 billion for the first nine months in 2006 to US\$ 228.2 billion. As noted above, short-term external debts rose to US \$94.6 billion at the end of the second quarter. However, the country's foreign exchange reserves are still more than enough to cover these short-term debts. Meanwhile, the Korea Investment Corporation (KIC) plans to invest US\$ 6.2 billion in bonds and stocks this year and expand its total investment to US\$ 20 billion by late next year, which is expected to raise the rate of return on the foreign exchange reserves and to promote the development of asset management companies.

#### **Monetary and fiscal developments**

13. The BOK kept its target for the benchmark call rate (uncollateralized call rate) steady at 4.5 percent in the last two months, after having raised it by a cumulative 125 basis points. The monetary tightening cycle could now be drawing to an end because of continued subdued inflation and the recent moderation in growth, although signs of acceleration in real estate prices still remain a concern. Meanwhile in August the BOK announced it would move from a core inflation target to one based on head line inflation next year, to better reflect living costs, while maintaining the current target range.

14. Korea's government has shifted its fiscal stance from proactive to neutral this year. The government did not frontload expenditure in the first half of 2006, as it had done in 2005, and will maintain a neutral stance in drafting the budget for 2007. Revenue and spending are expected to rise by 6.4 percent, with a shift towards social welfare expenditure, which will increase by over 10 percent. The fiscal balance excluding social security funds will continue to be in deficit by less than 1 percent of GDP in 2007. As a result, the

national debt will surpass Won 300 trillion or around one-third of GDP, which is low by the international standards

15. However, in the longer term there is a concern that the government's growing focus on welfare could pose heavier fiscal risks. The government aims to boost welfare spending to about 40 percent of the annual budget by 2030 from the current 25 percent. The rapid pace of population aging will place pressure on the National Pension Scheme (NPS), which commenced in 1998. In order to supplement the NPS, the government has introduced the Corporate Pension Scheme since the end of 2005, which amounted to Won 217.6 billion as of August 2006.

#### **Financial and Corporate Sector Developments**

##### *The performance of the banking sector*

16. Korea's domestic banks have continued to strengthen their financial position. The average non-performing loan ratio of the banks fell to 1.0 percent at the end of June 2006 from 1.2 percent at the end of 2005. 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 1.1 percent, 0.9 percent, and 1.8 percent, respectively. As a result of increased net income, the average capital adequacy ratio rose slightly to a record 13.1 percent at the end of June 2006 from 13.0 percent at the end of 2005. All banks reported capital adequacy ratios higher than 10 percent at the end of June 2006. Continued loan growth and a drop in provisioning for non-performing loans drove up banks' net income of the first half of 2006 by 23.4 percent over the previous year.

##### *The performance of the non-bank sector*

17. The six credit card companies have been improving in financial health. After registering combined net profits in 2005 for the first time for three years, they increased a profit to Won 1.7 trillion in the first half of 2006, up from Won 523.9 billion loss a year ago, due to a drop in bad

debt expenses. The average credit card delinquency ratio continued to decline to 8.0 percent at the end of June 2006, down from 10.1 percent at the end of 2005. The average capital adequacy ratio continued to rise sharply to 22.4 percent at the end of March 2006 from 19.0 percent at the end of 2005, as a result of increased profits and GE Capital International Holdings' equity investment in Hyundai Card. Meanwhile, net income of domestic securities companies rose sharply to Won 629.6 billion by 85.9 percent over the previous year during the first quarter of this fiscal year ending June 2006. A jump in commission income from brokerage and sales of mutual funds and beneficiary certificates contributed to the significant improvement of the net income.

### ***Restructuring of financial institutions***

18. This year has seen further consolidation of commercial banks and a move towards universal banking. Shinhan Bank and Chohung Bank merged in April as the three-year grace period of merger expired, which made Shinhan Bank the second largest bank after the Kookmin Bank. Kookmin Bank is also set to acquire LG card, the country's largest card issuer. Meanwhile, Kookmin Bank is in negotiation with a U.S.-based private equity fund to acquire Korea Exchange Bank.

### ***Developments in the capital markets***

19. Reflecting ample liquidity in the hands of large companies, domestic companies continued to scale down their fund raising through publicly offered debt and equity by 23.9 percent to Won 33.0 trillion for the first nine months of 2006. Equity financing totaled Won 4.5 trillion, marking a slight decrease of 4.2 percent from a year earlier. While SMEs increased equity financing by 11.7 percent, large companies reduced fund raising in stock markets by 13.9 percent. In addition, corporate bond issuance (excluding asset-backed securities and financial bonds) declined significantly by 34.4 percent over the previous year to Won 12.4 trillion during the period.

20. Issuance of asset-backed securities also decreased by 27.9 percent over the previous year to Won 15.0 trillion for the first nine months in 2006. The issue of mortgage-backed securities (MBS) plunged as consumers opted for mortgage loans by commercial banks rather than the Korea Housing Finance Corporation (KHFC) – a newly created mortgage finance entity in 2004. MBS issued by the KHFC totaled Won 721 billion in the first six months of this year, compared to Won 2 trillion a year earlier. Amid a weak demand for bank loans by large companies, banks have had a greater interest in extending loans to the household sector.

### ***Corporate sector developments***

21. In general, Korea's corporate sector remains healthy. According to the Financial Analysis compiled by the BOK, the average debt-to-equity ratio of Korean firms continued to decrease to 110.9 percent in 2005, the lowest level since 1966. The average debt-to-equity ratio of manufacturing firms stood at 100.9 percent in 2005, which is lower than that of the U.S. (136.5 percent at the end of 2005) and Japan (136.2 percent at the end of March 2005). The interest coverage ratio of Korean firms remained high by international standard at 460.3 percent, though it worsened moderately as the appreciation of the Korean won and a sharp rise in the oil prices squeezed corporate profits. However SMEs are still saddled with excessive debts. While over 3,500 SMEs have entered private debt workouts since July 2004, about 50 percent of them are still under the workout processes. However, in part thanks to guarantee by the government credit guarantee agencies, the delinquency ratio for bank loans to the sector continued to fall to 1.4 percent at the end of June 2006.

### ***Macroeconomic outlook***

22. A moderation of consumption and export is expected to result in overall GDP growth of 4.5 percent in 2007, compared to 5.1 percent in 2006. The economy is likely to make a soft landing, supported by the resilient export

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performance and health financial conditions of banks and large companies. Nonetheless, geopolitical risks, a sharper-than expected slowdown in the U.S. economy and still volatile oil prices could pose downside risks to the Korean economy.