Korea

The Korean economy expanded by 5 percent in 2006. Growth was supported mainly by stronger private consumption (4.2 percent), growth in facility investment (7.5 percent) and strong exports (13.0 percent). In the past few months, however, the economy has slowed, easing to 4.0 percent growth in the final quarter from 4.8 percent and 5.3 percent in the third and second quarter, respectively, principally due to weaker domestic demand. Private consumption moderated in the final quarter from recovery at a faster pace than household income since 2005. Slow growth in employment and income is likely to restrain private consumption growth in the near future. Fixed investment growth remained sluggish in 2006 with negative growth in construction investment, partly affected by government measures to curb speculation in real estate, although construction investment did begin to pick up slightly in the fourth quarter. Exports continued robust growth averaging 16 percent in the first two months of 2007, but is expected to slow with a slowing overall export environment.

Inflation has been subdued partly thanks to lower oil prices and the strengthening of the won. Headline inflation was 2.2 percent in February 2007, below the lower range of the central bank's medium term target of 2.5-3.5 percent. The Bank of Korea kept its target for the benchmark call money interest rate at 4.5 percent over the last seven months, after an earlier increase in rates by a cumulative 125 basis points. More subdued inflation, moderation in growth and high real estate prices are among the factors likely to determine the direction of monetary policy. Concerns about housing prices have led the government to speed up housing supply and to propose a housing bill that requires builders to disclose housing construction costs and to put price ceilings on new housing. Given the sluggish economy, the government has frontloaded government expenditure in the first half of 2007. The fiscal balance excluding the social security fund will continue to run a deficit of around 1 percent of GDP in 2007.

Even with robust exports and lower oil prices, the current account stayed at near balance, running a surplus of US$ 150 million in December 2006 and a deficit of US$ 500 million in January 2007, the latter due to increased consumer goods imports and a widening travel account deficit. This balanced current account trend is likely to continue through 2007. The capital account registered a surplus of US$ 18.6 billion in 2006 due to the increase in short-term borrowings by banks, despite net outflow of foreign portfolio investment and more overseas securities investment by domestic investors. Large net inflows of capital could serve to further strengthen the won and to further expand foreign exchange reserves, which reached US$ 242.8 billion as of February 2007. To mitigate the pressure, the government encouraged capital outflows by easing regulations on overseas direct and real estate investment, and by expanding tax incentives for overseas equity funds.

Moderating domestic and export demand is expected to result in slower GDP growth of 4.4 percent in 2007, a little lower than in 2006. The North Korean nuclear issue, volatile housing prices, won appreciation and higher oil prices could still pose a downside risk to the economy although recently those risks have been mitigated somewhat. The possibility of a sharper slowdown in the US economy and Presidential elections in December also could pose uncertainties to the economy.