

Korea

The Korean economy continues to expand. Real GDP growth, which had slowed to 4 percent year on year in the first quarter of 2007, recovered to 5 percent in the second quarter (the same pace as in 2006 as a whole). Growth was mainly led by improving domestic demand, as well as continued strength in exports. Exports have maintained a double-digit real growth thanks to solid demand from the Euro zone and China, in the face of strong won appreciation against the dollar. Facility investment and consumption rose respectively by 11.9 percent and 4.2 percent in the second quarter, backed by strong exports and solid equity prices. Construction investment returned to positive growth, up 3.5 percent at the first half of 2007. Robust exports and a steady rise in domestic demand are expected to sustain the momentum of growth in the latter part of 2007 and in 2008t, resulting in GDP growth of 4.8 percent in 2007 and 5.1 percent in 2008.

Headline consumer price inflation has been stable, running at 2.3 percent in the third quarter of 2007, below the central bank's medium term target range of 2.5-3.5 percent. Although consumer prices remain subdued, the Bank of Korea raised the overnight call rate twice by 0.25 percentage point to 5.0 percent in July and August. The overnight call rate target had been held at 4.5 percent for the previous 10 months. The BOK expects that inflation pressures may increase from the second half of this year into the first half of 2008 due to economic recovery, higher asset prices, the growth of liquidity and higher international oil prices. Given the sluggishness of the economy in late 2006 and early 2007, the government frontloaded fiscal expenditure in the first half of this year. The fiscal balance excluding social security funds is expected to remain in a very modest deficit of around 1 percent in 2007 and 2008.

The current account remains broadly in balance while net capital inflows continue at moderate rates. Double-digit export growth has been offset by high oil prices and a widening services account deficit. The services account deficit continued to expand as the demand for travel and education abroad increases. For the first eight months of 2007, the current account totaled a surplus of US\$ 0.5 billion, with a surplus of US\$ 19.0 billion on goods and a deficit of US\$ 14.7 billion on services. The current account is likely to continue in broad balance this and next year. The capital account recorded a surplus of US\$ 11.7 billion for the first eight months of this year. Short-term external borrowing, surged by US\$ 37.9 billion during this period, and was a main factor in the overall net capital surplus, given net outflows of direct investment and portfolio investment. Net capital inflows are anticipated to moderate as demand for hedging by shipbuilders slows and capital outflows by domestic investors increases, thanks in part to easier regulations and expanding tax incentives for overseas investment. Meanwhile, foreign exchange reserves reached US\$ 257.2 billion in September 2007, up US\$ 18.3 billion over the end of 2006.