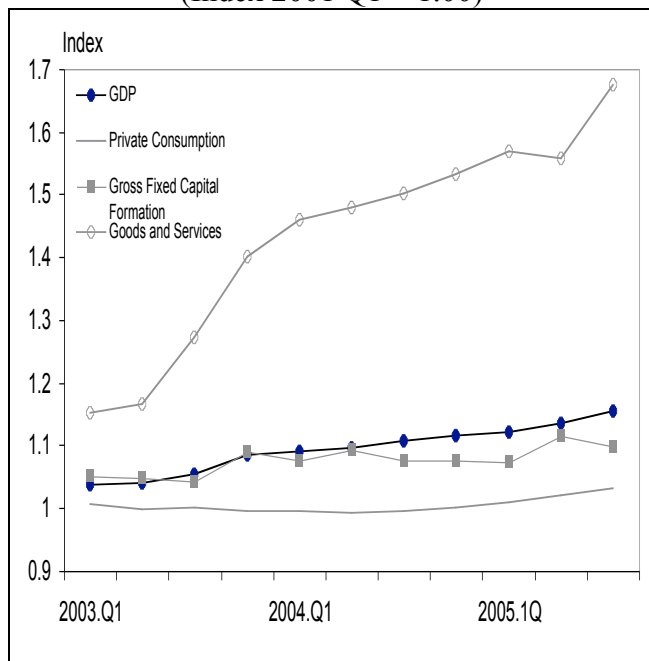


# KOREA

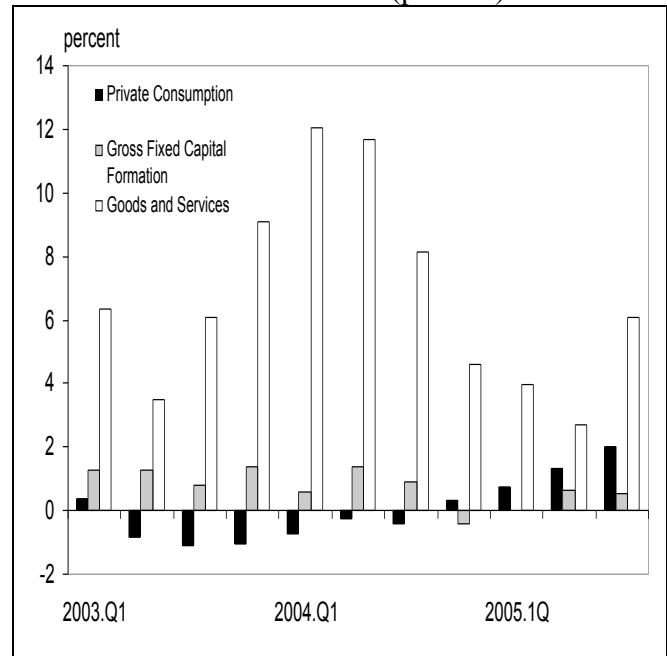
## Overview

1. Led by recovery of private consumption and a surge in global electronics demand, Korea's economy has been rebounding since the second quarter of 2005. Growth had slowed to a 2.7% year-on-year rate in the first quarter, affected by soaring oil prices and the strengthening of the won. Growth rebounded to 3.3% in the second quarter due to recovery of private consumption, and the recovery gathered momentum to 4.4% growth in the third quarter, thanks to a surge in exports. Meanwhile, with foreign exchange reserves exceeding US\$ 200 billion, the external position of the country has been further strengthened, although raising a policy challenge of how to deal with rising costs associated with reserve accumulation. The stronger external position of the country, the strengthening of bank balance sheets and North Korea's commitment to abandon its nuclear program in the six-party talks have all been positive for 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. On a national account basis, exports strongly rebounded to an 11.8% year-on-year growth in the third quarter of 2005, due to the bottoming out of demand for IT-related products including semi-conductors, electronic components and telecommunications equipment. Export growth had slowed for the five straight quarters, falling to 5.5% in the second quarter, due to a cooling of the global IT sector and the strengthening of won until April. On a customs clearance basis, exports to the U.S. declined by 8.0% over the previous year during July and August, which exhibited an improvement from a decline of 12.6% in the second quarter. Exports to China, the Korea's largest export market since 2003, continued to exhibit a double-digit growth of 25.6% in the first two months of the third quarter. Meanwhile, exports of textiles decreased substantially, due to the removal of export quotas of textiles at beginning of this year.

3. Down the road, export growth is expected to recovery further, in part backed by the weaker won this year, and acceleration of economic growth in Japan. After substantial appreciation in the previous three years, the exchange rate has reversed course since May, in part due to rising U.S. interest rates and the narrowing of Korea's current account surplus, returning to its level at the end of 2004. Going forward, the export recovery will depend in part on the strength of global electronics demand, as these products account for 40% of the country's exports.

4. Private consumption has continued to strengthen since the second half of 2004, due to a stabilizing of household debt outstanding and an improvement in the financial soundness of credit card companies. On a national account basis, private consumption rose by 4.0% over the previous year in the third quarter of 2005, compared to 1.4% and 2.8% in the first and second quarter, respectively. During the first half of this year, the volume of credit card usage jumped by 13.1% from a year ago, compared to a drop of 17.3% in the first half of 2004. Positive growth in lending to the household sector by financial institutions, in part backed by rising real estate prices, may have also increased private consumption.

5. Nonetheless, given sluggishness in adjustment of household balance sheets and lack of improvement in labor market conditions, private consumption growth is forecast to accelerate only moderately through 2006. Though household debt fell to 61% of GDP at the end of 2004 from its peak of 64% at the end of 2002, it rose back to around 62.5% in mid-2005. It still remains substantially higher than 40% in 1999 when the credit card boom commenced. The ratio of individuals' financial assets to their debts was 2.03 in the second quarter of 2005, which was almost unchanged from the end of 2003. In addition, higher oil prices have also led to worsening consumer sentiment since May. In the medium-term, there is also a concern over the impact of interest rate hikes on consumer spending through an increased interest payment

burden, as a major portion of household loans are contracted at floating rates.

6. On the other hand, recovery of facilities investment has not picked up, due to continued balance sheet adjustments in SMEs and a worsening of corporate profits resulting from the strengthening of the won and soaring oil prices. On a national accounts basis, facilities investment grew by 3.4% over the previous year in the first nine months of 2005, compared to a 3.8% increase in 2004. Corporate profits of listed companies fell by 11.6% in the first half of this year. Among them, the top ten companies, which are highly dependent on exports, saw their profits drop by 34.1%, largely due to foreign exchange losses of export proceeds.

7. Meanwhile, construction investment recovered in the second quarter of this year, posting a 1.7% year-on-year increase, led by a surge in housing investment. Housing prices had been stabilized by government measures in 2003 to restrain speculative investments in real estate, which eventually resulted in a negative growth of construction investment in the final quarter of 2004 and the first quarter of 2005. However, speculative housing investment demand has reemerged, due to a chronic shortage of housing supply in Seoul and a prolonged low interest rate environment. A greater interest in household lending by banks has also contributed to the revival, especially since corporations remain reluctant to borrow. Credits to households registered growth of 7.9% from a year earlier in the first half of 2005, compared to 6.1% in 2004 and 1.9% in 2003. Against this background, the government announced new measures to curb real estate speculation in August, which slowed down growth of construction investment to 0.4% in the third quarter. The measures address the demand side problem by imposing an ownership tax on real estate and raising capital gains tax on real estate transactions. On the other hand, housing supply is planned to be enhanced by securing new housing sites in the Seoul Metropolitan area, by utilizing national and public lands and by developing areas near the existing sites.

8. Looking ahead, growth of fixed investment is expected to accelerate moderately throughout 2006, owing to both export recovery and consumer spending. According to a survey by the Ministry of Commerce, Industry and Energy, the country's 200 biggest companies will increase facility investment by 24.3% over the previous year in the second half of this year, up from 10.9% in the first half. However, the persistent rise in oil prices could weigh on corporate spending, as suggested by the fact that business confidence deteriorated in the third quarter. Meanwhile, an expected increase of investment by public corporations in an effort to stimulate the economy will largely be offset by the effects of government measures to restrain the real estate boom.

9. The recovery of exports and private consumption translated into a rebound of industrial production. Growth of industrial production has risen sharply to a 6.3% year-on-year increase during July and August, compared to 3.8% in the first quarter and 4.1% in the second quarter. Meanwhile, the unemployment rate has been steady at around 3.6-3.8% since last year. In spite of the higher oil prices, inflation has been subdued due to the economic slowdown and the strengthening of won till the early part of this year. Core inflation rates were 1.9% in August and September, below the lower range of the Bank of Korea's medium term target of 2.5-3.5%. Import prices on won terms rose only 1.2% for the first eight months. However, it remains to be seen whether price stability will continue to be kept, given the continued run-up of oil prices and the weaker won since May.

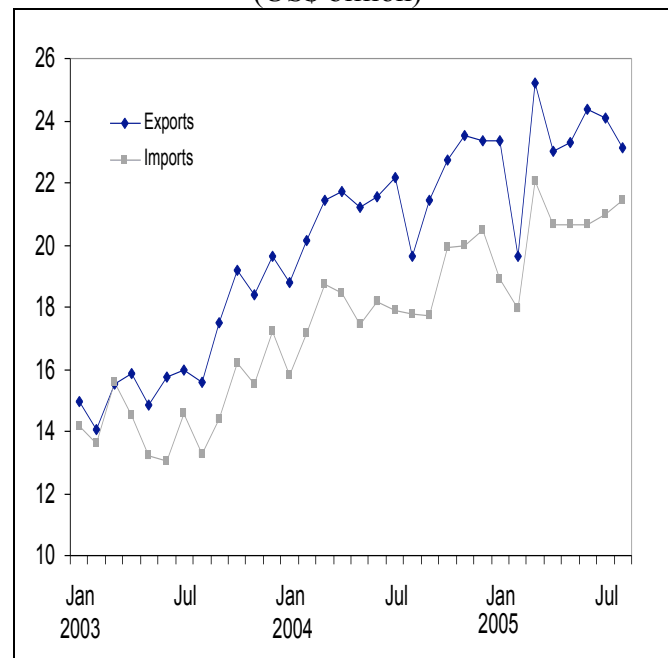
### **External Sector**

#### *Current account developments*

10. The current account surplus registered a surplus of US\$ 9.7 in the first eight months of 2005, decreasing by US\$ 7.8 billion or 44.5% from a year earlier, due to a combination of the following two factors. First, the trade surplus narrowed by US\$ 2.4 billion or 9.7% over the previous year to US\$ 22.8 billion during the

period, as imports rose by 22.8%, compared to a rise in exports by 11.6%. Strong import growth was the result of higher prices for crude oil and other raw materials. The unit value of imports rose by 10.2% during the first eight months of this year, compared to a marginal rise of the unit value of exports by 1.6%, which resulted in a continued deterioration of terms of trade. (On the other hand, export volumes grew at a faster pace of 8.2% than import volumes, which rose only 4.9%, reflecting weak domestic demand). Secondly, the services account deficit widened substantially by US\$ 4.0 billion to US\$ 9.5 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.

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

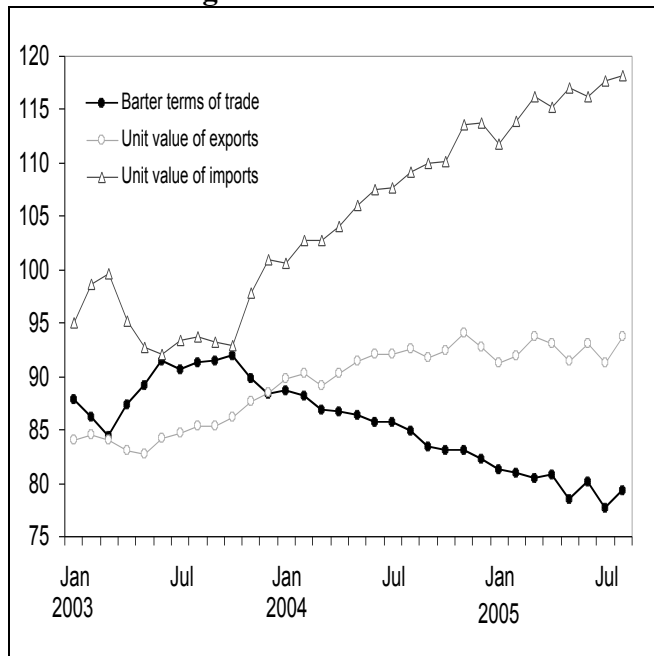


#### *Capital account developments*

11. The narrowing of the current account surplus was largely offset by a widening of the capital account surplus in the first eight months of 2005. Investment other than direct investment and portfolio investment registered a net inflow of US\$ 7.6 billion, compared with a net outflow of US\$ 13.0 billion a year ago, largely due to an increase in bank 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 Korean banks saw a continued downward trend in the spread of their borrowing rates against Libor; the Libor spread of 3-month borrowing narrowed to 11 basis points during the first half of this year from 15 basis points during the first half of 2004 and 12 basis points in the second half of 2004.

**Figure 4. Trade indices**



12. The direct investment account registered a net inflow of US\$ 0.3 billion in the first eight months of 2005, down by US\$ 1.4 billion from a year earlier. Foreign investment in Korea decreased in part due to cancellation of the acquisition of Inchion Oil by Chinese firm Sinochem, compared to the previous year, when a large inflow took place led by the Citigroup's acquisition of KorAM Bank and the Sinochem's acquisition. Foreign investment abroad continued to rise, led by investment in Asia, particularly China. On a notification basis, investment to Asia and China accounted for 64% and 42% of total foreign investment outflows, respectively, in the first half of this year, almost unchanged from 2004.

13. Portfolio investment registered a net outflow of US\$ 1.9 billion, compared to a large inflow of US\$ 12.4 billion a year earlier. The net capital outflow was attributed largely to a drop of stock investment by foreign investors, as they sold Korean stocks for profit taking. As a result, the ratio of non-resident holdings of stocks slightly declined to 41.7% in July 2005 from 42.0% at the end of 2004. Meanwhile, portfolio investment abroad was on a steady rise, partly due to low domestic interest rates. As of June 2005, the total foreign currency securities in the hand of Korean institutional investors totaled 34.7 billion dollars, which is still less than one fifth of the country's foreign exchange reserves. Among institutional investors, insurance companies held 54% of foreign currency denominated securities, while banks and asset management companies held 27% and 14%, respectively, at the mid-2005.

#### *Foreign exchange reserves*

14. The continued surpluses on both the current and capital accounts increased the country's foreign exchange reserves by US\$ 7.6 billion for the first nine months in 2005. As of the end of September, foreign exchange reserves stood at US\$ 206.7 billion, which is about 11 months of imports and more than 3 times Korea's short term debt outstanding.

15. With enough foreign exchange liquidity to cope with any sudden downward pressures to won, it is increasingly important for Korea's policy makers to strengthen management of the country's reserves. In July, the government launched the Korea Investment Corporation (KIC), which is to invest an initial total amount of US\$ 20 billion of foreign exchange reserves in foreign bonds and stocks. It is intended to improve the investment return on the reserves, as the cost associated with reserve accumulation, the interest burden on Monetary Stabilization Bonds and Foreign Exchange Stabilization Bonds, has been rapidly growing. The KIC is also expected to contribute to development of asset management industry by entrusting fund management to the industry. In addition, in the same month, the Bank of Korea has introduced currency swap contracts

to lend foreign exchange reserves to commercial banks. Commercial banks, in turn, extend soft loans for companies that need foreign currency for capital goods import, which is expected to boost economic growth potential and close the saving and investment gap of the country.

### **Monetary and fiscal developments**

16. The Bank of Korea (BOK) raised its target for the benchmark call rate (uncollateralized call rate) by 25 basis points from 3.25% to 3.5% in October for the first time since May 2002. The monetary tightening has been undertaken under a quite complex set of conditions. For one thing, it involves assessing whether higher and more volatile oil prices will have an inflationary or deflationary effect at this initial stage of economic recovery. It also involves considering how effective monetary policy will be to rein in the surge in real estate prices.

17. Meanwhile, the Korean government maintains a proactive fiscal stance. Government spending rose by 15% over the previous year in the first half of 2005, as a result of an increased annual budget by 9.5% and frontloading expenditures. Government expenditures in the first half of this year amounted to 59.3% of the annual budget, up 4.3 percentage points from the budget implementation rate a year earlier. In the second half, state companies are scheduled to make an additional investment of Won 2 trillion, which is 0.25% of GDP in help boost domestic demand. In addition, the government has started the Comprehensive Investment Initiative (CII) to stimulate private investment, by introducing “build-transfer-lease” transactions between the government and private developers. The CII involves construction of school, military barracks, toll highways, and rental housing. An estimated Won 2 trillion (0.25% of GDP) in private investment will take place in the second half of the year under the CII. Consequently, the fiscal outcome for this year is expected to stay in line with the budget, with fiscal policies consistent with achieving a balanced budget excluding social security funds.

## **Financial and Corporate Sector Developments**

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

18. Korea’s domestic banks have continued to strengthen their financial position. The average non-performing loan ratio of the banks fell to 1.6% at the end of June 2005 from 1.9% 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 1.7%, 1.4%, and 3.9%, respectively. As a result of increased net income, and a capital increases by the government in the Export-Import Bank of Korea, the average capital adequacy ratio rose to a record 12.6% at the end of June 2005 from 12.1% at the end of 2004. A drop in provisioning for non-performing loans and an increase in non-operating income on investment securities from improved performance of restructured companies drove up banks’ net income of the first half of this year by 81.6% over the previous year to Won 6.6 trillion.

19. Loans to SMEs, which account for about 40% of total bank loans, have not been a threat to Korea’s financial system. The non-performing ratio for loans to SMEs declined to 1.9%, compared to 2.2% at the end of 2004. Given that the bulk of loans to the industry are collateralized by real estate and guaranteed by the government credit guarantee agencies, potential losses would not cause major instability to the financial system.

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

20. The six credit card companies have been improving in financial health. Though they registered combined net losses of Won 523.9 billion in the first half of 2005, the loss came solely from Samsung Card, which recorded a net loss of Won 1.5 trillion in the first quarter, as it raised provisioning against bad loans in the interest of better asset management. All of the six credit companies registered profits in the second quarter for the first time since the third quarter of 2001. The average credit card delinquency ratio declined to 13.3% at the end of June 2005, the

lowest since the end of 2003. The average capital adequacy ratio rose to 17.6% at the end of June 2005 from 9.8% at the end of 2004 and negative 3.3% at the end of 2003, due to capital injections by their parent companies and debt-equity swaps with creditor banks.

21. Net income of domestic securities companies rose sharply to Won 338.3 billion in the first quarter of fiscal year 2005 ending June, from Won 143.3 billion a year earlier, thanks to restructuring efforts. The operating expenses dropped as a result of workforce downsizing and closing of branch operation. The number of employee and branches in the industry was cut by 9% and 8%, respectively over the year. Brokerage commissions decreased during the period, with a rise in stock trading volume more than offset by a decline in options and futures trading volume. Combined net income of non-life insurance companies also rose to Won 1.15 trillion in fiscal year 2004 ending March 2005, from Won 564.3 billion a year ago. This improvement was due to a jump in investment income, largely from valuation gains of derivatives, and a decrease in net expense and loss ratios.

### ***Restructuring and re-capitalization of financial institutions***

22. Rising foreign ownership of Korean commercial banks has been exerting substantial competitive pressure on domestic banks. Following Citigroup's purchase of KorAm Bank last year and Standard Chartered Bank's purchase of Korea First Bank in February this year, there has been speculation that Lone Star Funds, the U.S.-based private equity fund is set to sell Korea Exchange Bank to a foreign bank after November, when the mandatory ownership period expires. Currently, Citibank Korea and Korea First account for 14% of total assets of 8 nation-wide banks, while Korea Exchange accounts for 9%.

23. Meanwhile, the public sector's ownership of financial institutions continued to be scaled back. Korea Deposit Insurance Corporation (KDIC) is expected to sell a portion of its stake in Woori Financial Holding Company to overseas

investors after its sale of a 6% stake in last year. Other KDIC stakes in two investment trust companies, Daehan Investments and Korea Investment and Securities Company, were sold in the first half of this year. The government estimated in 2002 that Won 69 trillion would not be recovered, which is about 40% of total public funds injected to the financial system. The cost is scheduled to be shared by the government (Won 49 trillion) and financial institutions (Won 20 trillion).

24. Creditor banks of LG card are set to sell their stakes to investors, including foreigners, after making a massive injection of funds to the credit card issuer. Domestic banks have been expressing their interest in taking over the credit card company. As the systemic risk from default by credit card companies has fallen, the authorities increasing their focus on upgrading the quality of risk management in the industry, to avoid a recurrence of crisis. As its first step, the Financial Supervisory Service reviewed credit card companies' risk management systems from June to September, and will set Best Practice for Risk Management, which will include criteria for risk management methods, operation of risk management units, and methods of validating and back-testing credit scoring systems.

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

25. Reflecting an uncertain investment climate and ample liquidity in the hand of corporations, equity financing totaled Won 4.2 trillion in the first eight months of 2005, marking a sharp decrease of 42.1% from a year earlier. Similarly, corporate bond issuance (excluding asset-backed securities and financial bonds) totaled Won 15.7 trillion, down 3.3% over the previous year. On the other hand, asset-backed securities (ABS) issuance totaled Won 14.3 trillion in the first half of this year, up by 26.4% from a year earlier. This increase was mainly due to a surge in commercial mortgage backed securities for real estate development (project finance) and mortgage backed securities issued by the Korea Housing Finance Corporation. Investors have increased their appetite for ABS amid a prolonged low

interest rate environment, with increased purchase of ABS with a BBB credit-grade since the second half of 2004.

26. Korea's mortgage-backed securities (MBS) market has been expanding steadily. The MBS issued by Korea Housing Finance Corporation (KHFC) -- a newly created mortgage finance entity in 2004 -- totaled Won 2.2 trillion in the first half of 2005, compared with last year's total of Won 3.0 trillion. The KHFC plans to issue Won 400-500 billion in MBS each month and to issue a total of Won 38 trillion over the next five years through 2009. Development of MBS market is expected to offer long-term investment option to institutional investors, as well as to facilitate growth of long-term bond market.

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

27. In general, Korea's corporate sector remains healthy, though small and medium enterprises are still saddled with excessive debts. According to the Financial Analysis compiled by the BOK, the average debt-to-equity ratio of Korean firms continued to decrease to 114.0% in 2004, the lowest level since 1966. The average debt-to-equity ratio of manufacturing firms stood at 104.2% in 2004, which is lower than that of the U.S. (141.2% at the end of 2004) and Japan (145.4% at the end of March 2004). Also, the interest coverage ratio of Korean firms continued to improve to 483.4% in 2004, up from 351.2% in 2003, a remarkable improvement from 115% in 1997 when the crisis took place. Given continued profits registered by listed firms, financial health of large Korean firms remains intact this year.

### **Macroeconomic outlook**

28. A continued recovery of both external and domestic demands is expected to result in overall GDP growth of 4.6% in 2006, compared to 3.8% in 2005. The balance sheet adjustments in the household sector and SMEs will continue to weigh on the economic expansion. External shocks including persistent high oil prices and reversal of demand for IT-related products could pose a substantial downside risk to the highly

open economy. However, once external factors become favorable, improved business confidence could result in a sharp recovery of corporate spending, supported by the highly strengthened financial position of large firms and banks.