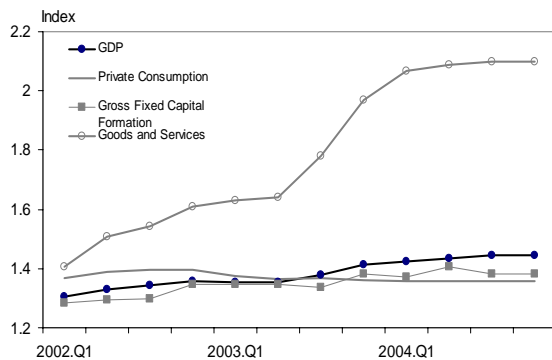


## Overview

Led by strong export demand, Korea's economy rebounded to a 4.6% year-on-year real growth rate in 2004 from the previous year's low 3.1% GDP growth. However, on a quarter-on-quarter seasonally-adjusted basis, economic growth slowed from 6.0% on an annualized basis in the second half of 2003 to 4.7% in the first half of 2004 and further to 3.2% in the second half of the year, on the back of slower export demand and a sharp contraction in construction investment. Under this circumstance, a revival in private consumption is key to sustainable growth, as consumer spending accounts for about half of the country's gross domestic product. Recent economic reports show a sign of bottoming out in consumer spending. It remains to be seen whether these results represent a solid and sustainable recovery, since indebted households are still continuing to repair their balance sheets. With export growth expected to be slowing due to a somewhat slower pace of growth in demand from China and the rest of the world economy, and with recovery in domestic demand expected to be a slow, GDP growth is projected at 4.2% for the year, compared to 4.6% in 2004. Meanwhile, credit card companies received a boost to their financial health, thanks to a capital injection from their parent firms and creditor banks, lessening financial system risks.

**Figure 1. Real GDP and expenditures**  
(Index 1998 Q2 = 1.00)



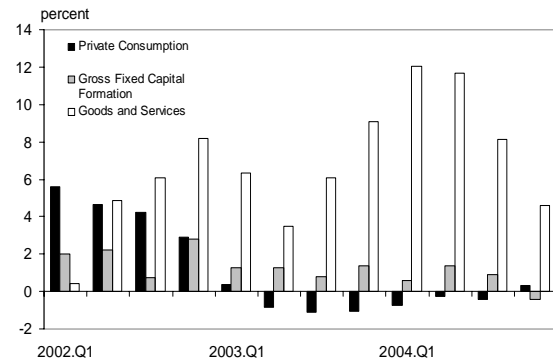
## Recent Macroeconomic Developments

### Output, employment and inflation

On a national account basis, exports of goods boomed to a 21% increase in 2004, up from an 18.5% increase in the previous year. However, on a quarter-on-quarter seasonally-adjusted basis, export growth moderated from heady 37% annualized pace in the second half of 2003 to 22.1% in the first half of 2004 and further to 6.5% in the second half of the year, due to slower growth in global IT demand and in import demand from China. Nevertheless, exports to China, Korea's largest export market since 2003, have continued to outperform those to other countries. On a customs clearance

basis, exports to China grew by over 40% for the year in dollar terms.

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



Both the Korean authorities and private analysts project a slowdown in exports for this year, on the back of slower world economic growth and slower growth in demand for IT-related products. The strengthening of the won, which appreciated by 13% against U.S. dollar last year, is also expected to have a lagged impact on Korea's exports, given that much of the appreciation occurred in the last quarter and its effects may have yet to materialize. The Bank of Korea (BOK), for instance, projects that growth of goods exports will decelerate to 9.8% this year in real terms.

With a projected softening in demand for exports throughout this year, a recovery of domestic demand is key to sustainable and broader economic recovery. On a national account basis, private consumption contracted by 0.5% in 2004 following a decline of 1.2% in the previous year. However, private consumption registered a slightly positive growth of 0.9% in the second half of 2004 over the previous half. The level of fourth quarter consumption was higher than a year ago, for the first time in the past seven quarters. Probably reflecting the recent stabilizing of household debt outstanding; consumer confidence improved for the third straight month in March this year.

Nonetheless, given the size and complexity of the household debt overhang, the recovery in private consumption is forecast to be moderate. By late 2004, about 10% of the adult population was classified as being delinquent. Though household debt fell to 59% of GDP in mid-2004 from 62.5% in the fourth quarter of 2002, it still remained substantially higher than 37% in early 1999, before the credit card boom commenced. The Korean authorities and the financial institutions have moved to establish several programs through which credit card debts are restructured. However, so far, only about 15% of delinquent debtors have benefited from these programs, due to creditor coordination

problems regarding debtors with multiple debts and lack of basic information on debtors' ability to pay.

Weak construction investment also contributed to holding back economic recovery last year. Growth in construction investment decelerated sharply to 1.1% in 2004 from 7.9% in 2003, due to policy measures to restrain speculation in real estate. Starting in the fourth quarter in 2003, taxes on property holdings and capital gains were increased in order to slow the rapid increase in property prices. On a quarter-on-quarter seasonally-adjusted basis, construction investment has contracted for the past four consecutive quarters. On the other hand, investment in machinery and equipment recovered to 3.8% growth in 2004 from 1.2% contraction in 2003, based on strong profit performance, high capacity utilization of large firms and a record low interest rate environment.

Recent economic reports suggest investment in machinery and equipment is likely to continue to recover for this year; the Business Confidence Index improved for the third consecutive month in March this year. However, the recovery is expected to be moderate, due to the uncertainty about the future course of external demand and consumer spending, and continued balance sheet adjustments by small and medium sized enterprises. Given that construction investment accounts for more than half of gross fixed investment, investment as a whole is unlikely to pick up strongly.

Moderation in export growth and weak construction investment translated into a weaker trend in industrial production growth throughout last year. Though industrial production rebounded sharply toward the end of the year, it remains to be seen whether that represents the start of long term recovery, especially given the large contribution of inventory building to recent the production increase. The unemployment rate has been steady at 3.4-3.7% since the second half of last year. In some part due to the appreciation of the won during 2004, core inflation averaged 2.9 percent last year, which was well within the Bank of Korea's medium term target range of 2.5-3.5%.

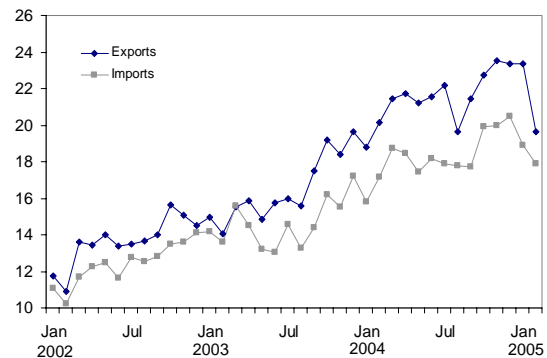
## External Sector

### Current account developments

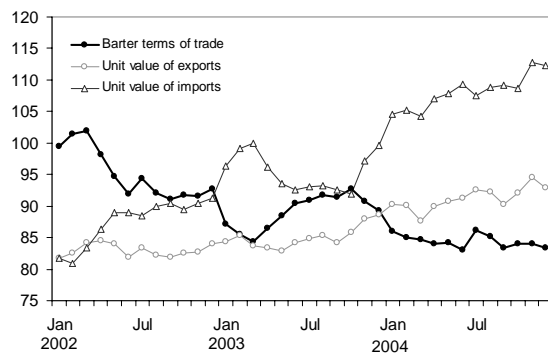
The current account surplus widened for a second consecutive year to US\$ 27.6 billion (4.1% of GDP) in 2004 from US\$ 12.0 billion (1.8% of GDP) in 2003. This surplus was the second largest, following the peak of US\$ 40.4 billion in 1998. Exports increased strongly by 30.6% in dollar terms, while imports also showed a high rate of increase by 25.2%. The terms of trade deteriorated significantly, however, as higher prices of crude oil and other raw materials drove up the unit value of imports by 13.3% for the year, compared to a milder rise in the unit value of exports by 7.3%. On the other hand, export volume

grew at a much faster pace at 23.0% than import volume at 10.9%.

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



**Figure 4. Trade indices**



From the viewpoint of savings and investment gaps, a continued rise in the saving-to-GDP ratio contributed to the widening of the current account surplus. The savings-to-GDP ratio rose sharply for the second consecutive year from 33% in 2003 to 35% in 2004, the highest since the level of 35.8% in 1999. On the other hand, the investment-to-GDP ratio remained at 30.2% in 2004, compared to 30.0% in 2003. As domestic demand is expected to recover only moderately, the current account surplus is unlikely to narrow sharply this year.

### Capital account developments

The net foreign direct investment account registered a larger net inflow of US\$ 3.4 billion in 2004, compared to US\$ 1 billion in 2003. Foreign investment to Korea resurged to US\$ 8.2 billion, the highest inflow in the past four years, led by Citigroup's acquisition of KorAM Bank and the capital inflow from a Chinese firm Sinochem for its acquisition of Incheon Oil. Foreign investment abroad also continued to rise to US\$ 4.8 billion in 2004, compared to US\$ 3.4 billion in 2003, owing to investment in Asian and North American subsidiaries.

Portfolio investment continued to be a dominant source of capital account surplus in 2004, registering a net inflow of US\$ 9.3 billion in 2004. Foreign investment to Korea posted a large inflow of US\$ 16.8 billion, due to the inflow of foreign capital for stock investment and to a significant increase in the issuance of overseas bonds by financial institutions. The ratio of non-resident holdings of stocks has now risen to 42% at the end of 2004 from 40.1% at the end of 2003, the highest in the region. Portfolio investment abroad also increased to US\$ 7.5 billion for the year, owing to increased investment by institutional investors in stock and bonds. Meanwhile, foreign banks have been increasing their exposure to Korea since 2002, as the creditworthiness of the country has progressively strengthened.

#### *Foreign exchange reserves*

The continued surpluses on both the current and capital accounts have resulted in a sharp accumulation of reserves to US\$ 199.1 billion at the end of 2004 from US\$ 155.4 billion at the end of 2003, as well as having generated persistent upward pressure to the exchange rate of the won. Indeed, Korea is currently the fourth largest holder of reserves globally, after Japan, China and Taiwan (China). As of March 2005, foreign reserves stood at around US\$ 205.4 billion, amounting to 11 months of imports and more than 3 times Korea's short term debt outstanding. Even if a sudden shock were to lead to capital outflows from the domestic stock market, the current reserve levels would almost cover the sum of the stock of short term debt outstanding and non-residents' stock holdings.

With the sharp rise in reserve levels, the BOK has recently expressed its intention to diversify its portfolio. In February this year, the BOK submitted a report to the National Assembly, which included a statement regarding its intention to increase investments in high-yielding, non-government debt, such as papers issued by financial institutions and asset backed securities, and to diversify its holding into a variety of currencies. In addition, the government has decided to establish the Korea Investment Corporation (KIC) in the first half of this year, which will manage an initial total amount of US\$ 20 billion, about 10% out of the country's foreign reserves. The KIC will entrust its funds to private asset management companies which are supposed to invest in overseas stocks and bonds. The government expects that this move will contribute to the capacity-building of the domestic asset management industry as well as help earn higher returns on the reserves.

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

Given the moderation in output growth and subdued inflation during 2004, the BOK lowered its target for the benchmark call rate (uncollateralized call rate) by 25 basis points in August and again in November. Call rates are now at a historical low at 3.25 percent. The additional monetary ease came in November amid concern about downside risk

to economic growth due to the slowdown in export growth and construction investment. Yet, the BOK remains concerned about the medium-term evolution of price movements on the back of high oil prices and housing prices.

The government also eased fiscal policy by frontloading expenditures and enacted a supplementary budget worth about 0.5% GDP in 2004, which resulted in a deficit (consolidated budget balance, excluding social security fund surplus and the conversion of KAMCO and KIC bonds) of 0.9% of GDP from a surplus of 0.2% in the previous year. The government also plans to increase expenditure by 9.5% in 2005 and intends to maintain a proactive stance by frontloading fiscal expenditure and reducing income tax rates and withholding tax rates on interest and dividend income. The 2005 fiscal balance is targeted to a deficit of 1.0% of GDP and the government debt including contingent liabilities is projected to be less than 40%, which is far below the OECD country average of about 80%.

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

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

Korea's 19 domestic banks have continued to strengthen their financial positions. The average non-performing loan ratio of the banks continued to fall, reaching 1.9% in 2004 from 2.6% in 2003. As the end of 2004, none of the domestic banks had a non-performing ratio above 3%. As a result of general increases in net income, as well as a capital increase by the government in Korea Development Bank, the average capital adequacy ratio rose to a record high 12.1% in 2004 from 11.2% in 2003. A drop in provisioning for non-performing loans, higher interest income from increased lending, and special gains from deferred taxes drove up banks' net income to a record high Won 8.8 trillion in 2004. Even after excluding Won 3.6 trillion for one-off profits such as deferred taxes and valuation and realized capital gains, net income for the year comes to Won 5.2 trillion, a jump from Won 1.7 trillion a year earlier when credit card default and corporate fraud hit the sector. Return on assets rose to 0.85% from 0.17% and return on equity to 15.2% from 3.4% a year earlier.

There is still a concern over potential losses on loans to small and medium sized enterprises (SMEs), which account for about 40% of total bank loans. However, given that a large portion of loans to the industry is collateralized by real estate and guaranteed by the government credit guarantee agencies, it is unlikely that they would be a threat to Korea's financial system unless the economy experienced an unexpected downturn and sharp asset deflation. To date, banks have rolled over most of loans to SMEs, due to government moral suasion and recapitalization of its two guarantee agencies Korea Credit Guarantee Fund and Technology Credit Guarantee Fund.

On the longer horizon, Korea's Financial Supervisory Service encourages the banks to raise the proportion of non-interest income. The proportion of non-interest income in total income increased sharply to 18.1% in 2004 from 14.0% in 2003, due to introduction of bancassurance, the sale of beneficiary certificates and a hike in bank fees on asset securitization, but remained low compared with those of many leading foreign banks (e.g., 27.7% average for U.S. commercial banks).

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

The 6 credit card companies improved their financial performance in 2004. The combined net income of the credit card companies was in deficit up to the third quarter of 2004, but showed an overall improvement in the fourth quarter, posting a surplus of Won 254.5 billion. The average credit delinquency ratio fell to 18.2% at the end of 2004 from 28.3% at the end of 2003. The average capital adequacy ratio rose to 9.8% at the end of 2004 from negative 3.3% at the end of 2003, due to capital injections by their parent companies and debt-equity swaps with creditor banks.

Net income of 42 domestic securities companies was down to Won 283.8 billion in the first half of the fiscal year 2004 ending September from Won 689.1 billion in the previous year, on lower stock prices and thinner trading volume. On the other hand, the combined net income of non-insurance companies rose sharply to Won 697.0 billion from Won 541.4 billion, due to rises in premiums on automobile and casualty insurance.

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

Korea continues to show progress not only in restructuring its financial institutions but also in promoting greater competition in its financial service industry. Following Citigroup's purchase of KorAm Bank last year, Standard Chartered Bank acquired Korea First Bank from Korea Deposit Insurance Corporation and U.S. investment fund New Bridge Capital in February this year in order to take a strategic position in Korea. These acquisitions have led to a new period of global competition in the country. HSBC also expressed its intention to hire employees in Korea at a faster rate than anywhere in Asia after failing to buy Korea First Bank. As a result of re-privatization of Korea First Bank, the government now holds stakes only in two banks.

Credit card companies have been restoring financial health as a result of recapitalization by their parent companies or creditor banks. At LG card, which was operating with negative capital, creditor banks agreed on an additional infusion and shareholders agreed on capital reduction this year. Capital increases by Hyundai Card last August pushed up its capital adequacy ratio to above the management guideline ratio of 8%. In addition, Samsung group plans to

inject additional capital to Samsung Card. Combined with a sharp decline of the credit card companies' bonds in the hand of institutional investors, the risk of systemic contagion has substantially lessened.

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

Due to the slow economic recovery, domestic company issuance of stocks and bonds totaled Won 58.7 trillion in 2004, down 19.5% from a year ago. Equity financing totaled Won 8.3 trillion last year, marking a 25.5% decrease, due to bearish stock markets in the first half of the year. Corporate bond issuance amounted to Won 50.4 trillion last year, also down 18.4% from a year ago, due to a sharp decline in issuance of financial bonds and asset-backed securities (ABS) by credit card companies. However, corporate debt issues, excluding financial bonds and ABS, rose sharply by 42.9% in 2004 to Won 26.2 trillion, helped by BOK's two rate cuts, sending the 3-year treasury bond yield to a record low 3.3% at end of 2004.

Korea's mortgage-backed securities (MBS) market expanded rapidly last year though it was in the incipient stage. The MBS issued by Korea Housing Finance Corporation --- a newly created mortgage finance entity in March 2004 --- totaled Won 3.3 trillion, compared with a four-year total of Won 2.9 trillion by its predecessor Korea Mortgage Corporation. The issuance of MBS with maturity of 10 years or longer is expected to strengthen the ground for the developing a longer-term bond market.

There was also progress in development of the regional bond market last December. The Korean and Japanese governments introduced the first Japanese yen-denominated Primary Collateralized Bond Obligations issued by small and medium sized Korean enterprises. The transaction involves the securitization of a portfolio of Korean corporate bonds that have been credit-enhanced by the Industrial Bank of Korea and Japan Bank of International Cooperation.

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

Korea's large corporate sector remains healthy. The economic recovery and continued restructuring efforts allowed listed manufacturing companies on the Korea Stock Exchange to further improve their financial positions. The sales, operating income and current income rose by 19.4%, 51.7% and 69.1% respectively for the first half of fiscal year 2004, ending September. Debt-to-equity ratios fell to 92.9% at the end of September 2004 from 100.9% at the end of March 2004.

In contrast, SMEs remain saddled with excessive debts. According to the Financial Analysis compiled by the BOK, 26.6% of manufacturing SMEs in 2003 were not generating enough revenue to service their interest payments, up from 23.1% in 2002. Meanwhile, the government has established a credit bureau for SMEs by spinning off credit information

units from the two government credit agencies, to share information on the sector with private financial institutions.

The National Assembly passed a new bankruptcy law in February this year. Since the aftermath of the currency crisis in 1997-98, the country's complex bankruptcy law has been considered to be a serious impediment to corporate restructuring. The integrated and simplified law is designed to help viable companies with short-term liquidity problems more rapidly normalize their operations. Under the new comprehensive bankruptcy law, companies facing worsening business will only be required to go through a workout program with approval from a court to revive their business operations.

### **Macroeconomic outlook**

We are projecting GDP growth of 4.2% for Korea this year, compared to 4.6% in 2004, based on expectations of a moderate recovery in domestic demand. The projected growth rate is still higher than those for most OECD countries. While the financial de-leveraging in the household sector and small and medium sized enterprises will continue to weigh on the economy, the strengthened financial position of commercial banks and large enterprises could help the economy gather upward momentum as well as serve as a buffer against shocks. The relatively favorable fiscal position of the government also gives it considerable flexibility in responding to unexpected shocks.