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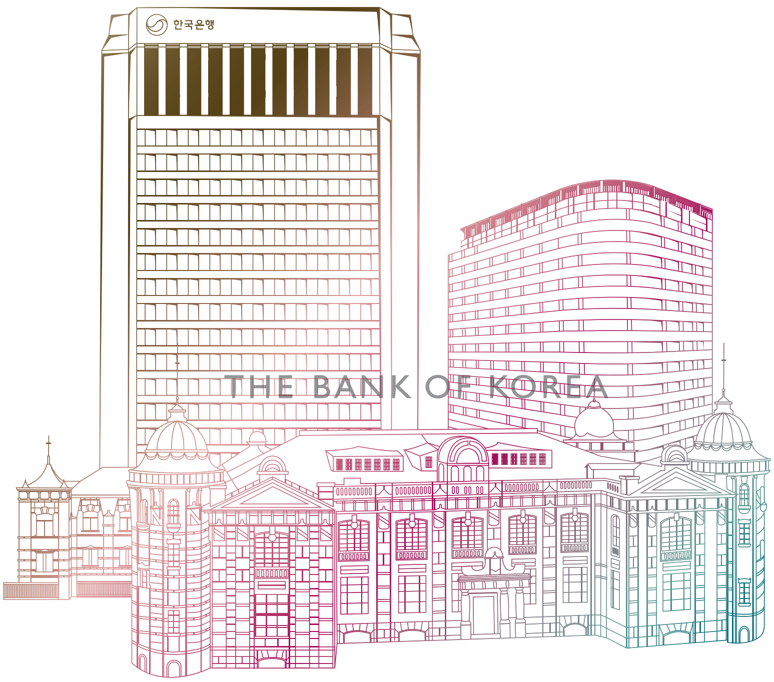
Monetary Policy Report

April 2012



THE BANK OF KOREA

Monetary Policy Report

April 2012

This Monetary Policy Report is published in accordance with the provisions of Article 96 of the Bank of Korea Act, and upon the resolution of the Monetary Policy Committee.

April 2012

Kim, Choongsoo
Governor
the Bank of Korea

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■Executive Summary

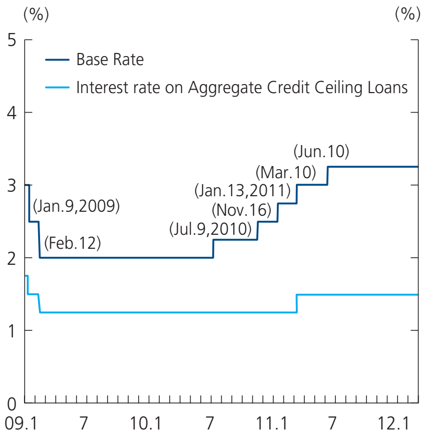
1 The Bank of Korea, closely monitoring financial and economic risk factors both at home and abroad, conducted its monetary policy from the latter half of 2011 with an emphasis on ensuring that the basis for price stability was firmly anchored while the economy continued its sound growth.

2 In keeping with this policy stance, the Bank maintained the Base Rate at 3.25% and the interest rate on its Aggregate Credit Ceiling Loans at 1.50%.

The rationale for maintaining the Base Rate at 3.25%, even despite the continued high rate of increase in the consumer price index (CPI) during this period, was that the downside risks to growth and volatility of the financial and foreign exchange markets had expanded, due for example to the sovereign debt problems in Europe, the slowdowns of major economies, and international financial market unrest, while it was expected that the upward pressures on prices would ease somewhat in 2012.

3 Meanwhile, the Bank continued its efforts to withdraw the liquidity it had provided during the global financial crisis. In the second half of 2011, it withdrew the outstanding balance of the 1.3 trillion won of its support provided to the Bond Market Stabilization Fund, and also made a further reduction of 1.5 trillion won provided in support of the Bank Recapitalization Fund.

Bank of Korea Base Rate and interest rate on Aggregate Credit Ceiling Loans



Source: The Bank of Korea.

Supply of liquidity to counter the global financial crisis, and its withdrawal

	Type	Scale	Withdrawal
Korean Won Liquidity (trillion won)	•Bank Recapitalization Fund	3.3 (0.5)[1]	Support still provided
	•Aggregate Credit Ceiling Loans	3.5 (1.0)[1]	
	•Bond Market Stabilization Fund	2.1 (0.0)[1]	Entire amount withdrawn
	Sub-total	8.9 (1.5)[1]	-
	•Unscheduled ad hoc RP purchases	16.8	Entire amount withdrawn
	•Other Korean won liquidity[2]	2.3	One-off support
	Total	28.0	-
Foreign Currency Liquidity[3] (billion dollars)		26.8	Entire amount withdrawn

Notes: 1) Figures in parentheses are end-February 2012 basis.
2) Outright purchases of Treasury bonds, repurchases of MSBs prior to maturity, etc.
3) Foreign currency swaps, foreign currency loans, etc.
Source: The Bank of Korea.

Consequently, the outstanding balance of the liquidity supplied to counter the global financial crisis but not yet collected was reduced as of end-February 2012 to 1.5 trillion won — consisting of the increase in the Aggregate Credit Ceiling (1.0 trillion won) and support for the Bank Recapitalization Fund (0.5 trillion won).

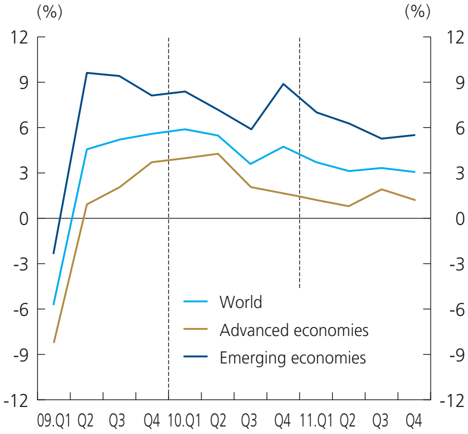
4 In tandem with this, the Bank devoted a wide variety of efforts to minimizing the influence of destabilizing factors in financial and foreign exchange markets - such as the expanded volatility of capital in- and outflows, the spread of the sovereign debt problems in Europe, and the increase in uncertainties related to North Korea.

First, the Bank strove in concert with the government to enhance the effectiveness of macro-prudential policies related to the foreign exchange sector. It implemented supplementary measures including lowering the ceilings on foreign exchange banks' FX forward positions and restricting their investment in foreign currency-denominated bonds issued domestically for the purpose of Korean won financing. At the same time it adopted measures to facilitate seamless implementation of the Macro-prudential Stability Levy. While constantly monitoring Korean won and foreign currency liquidity conditions in the financial markets and the movements of price variables, it promptly put into operation emergency responses such as the 'Monetary and Financial Action Task Force', when factors disruptive to the markets occurred, including the downgrade of the US sovereign credit rating and the death of North Korean leader, Kim Jong Il,. To enhance the Bank's capacity for responding to external shocks, moreover, the sizes of its swap arrangements with Japan and China were enlarged.

Apart from this, to heighten the effectiveness of other monetary policy instruments, such as reserve requirements and Aggregate Credit Ceiling Loans, the Bank improved the related systems. First, in reflection of the revised Bank of Korea Act and its enforcement decree, which came into effect from December 17, 2011, the Bank drew up the regulations for imposition of reserve requirements on certain types of financial bonds, while revising the periods of calculation and maintenance of required reserves from semi-monthly to monthly. In addition, to induce financial institutions to extend credit loans to SMEs, whose capacities to obtain credit on the basis of collateral are fragile, it also set up a 'Special Support Ceiling Linked to Credit Loans to SMEs', which brings into effect on April 2, 2012.

5 The financial and economic conditions at home and abroad that formed the backdrop to these monetary policies are set out in what follows. In the world economy, first of all, the trend of recovery has shown signs of faltering as the negative impacts on the real economy of the continued deterioration of the sovereign debt problems in Europe during the latter half of 2011 have spread to emerging market countries.

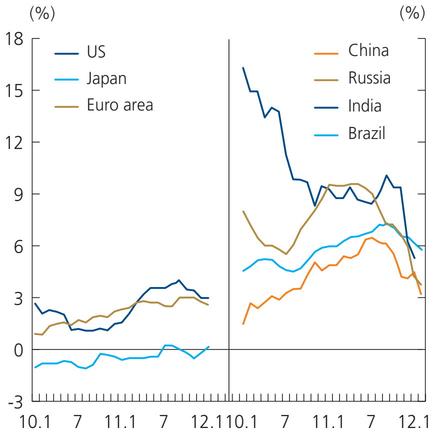
Economic growth[1] of advanced[2] and emerging[3] economies



Notes: 1) Annualized percentage changes from the preceding quarters.
2) 34 countries including US, UK, and NIEs (newly industrialized Asian economies - Korea, Taiwan, Hong Kong, and Singapore).
3) Emerging and developing economies.
Source: IMF, World Economic Outlook Update, Jan. 2011.

The upward trend of global inflation flattened out from the beginning of the latter half of the year, thanks to the stabilization of international commodity prices and the easing of demand side pressures in line with the world economic slowdown. High inflation expectations and a renewed rise of international oil prices, due to geopolitical risk in the Middle East, nevertheless have remained as potentially destabilizing factors to prices.

CPI inflation[1] in major economies



Note: 1) Compared with the same months of the previous years.
Sources: Individual countries' published statistics, apart from euro area's which is published by Eurostat.

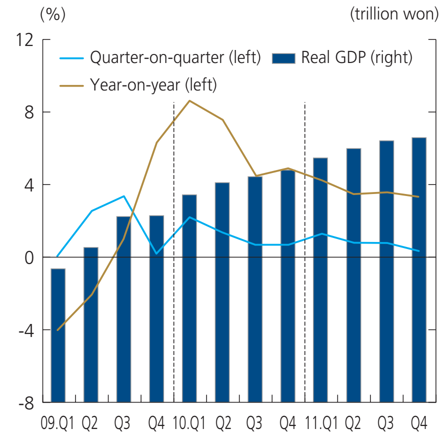
The international financial markets exhibited a highly unstable pattern from August 2011 onwards, owing to the downgrade of the US sovereign credit rating and the worsening of the sovereign debt problems in Europe. Share prices and long-term interest rates plunged together, and credit spreads widened, in line with a heightened tendency toward preference for safe-haven assets and the strengthening of financial institutions' efforts to secure liquidity. The market unrest gradually eased from late December, however, thanks to the ECB's large-scale provision of long-term liquidity.

Advanced and emerging economy share price indices

Source: Bloomberg.

6 Looking at the domestic economy, its trend of growth showed signs of slowdown in the second half of 2011, amid the mounting uncertainties as to external conditions including the sovereign debt problems in Europe. Real GDP growth (quarter-on-quarter), after running at 0.8% (3.6% year-on-year) in the third quarter, fell to 0.3% (3.3% year-on-year) in the fourth quarter, as exports and domestic demand declined owing to the slowdown of world economic growth and contractions of consumer and investment sentiment. Economic activity remained subdued from early 2012, as well.

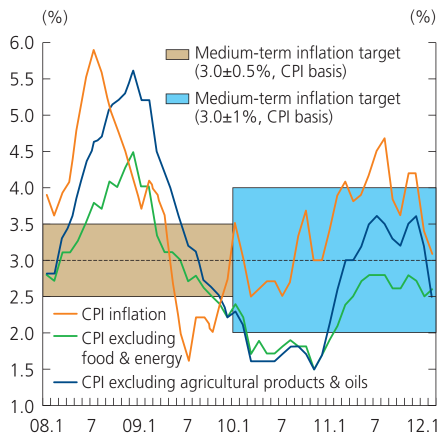
Real GDP growth rates



Source: The Bank of Korea.

7 After registering 4.7% in August 2011, consumer price inflation (year-on-year) gradually fell, owing to the slackening of domestic economic activity and the stability of agricultural and livestock product prices, but nevertheless exhibited a high level of

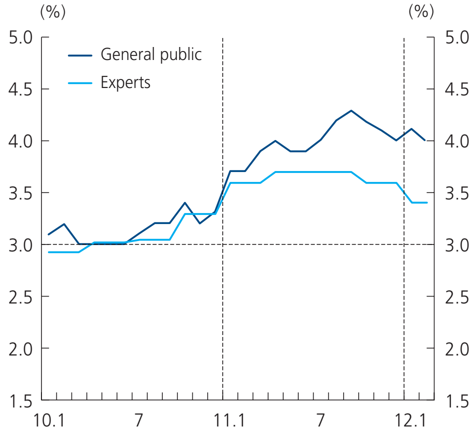
CPI and core inflation[1)]



Note: 1) Compared with the same months of the previous years.
Source: Statistics Korea.

around 4%. The rate of core inflation also maintained a high level as supply shocks, due for example to the sharp run-ups in international oil prices, passed through with some time lag to drive up the prices of other commodities. From the beginning of this year, both consumer price inflation and core inflation exhibited patterns of deceleration mainly due to the base effect. As estimated through the Bank of Korea's regular survey of economic agents, inflation expectations have meanwhile shown only a slow retreat from their high level of between around 3.5% and slightly over 4.0%.

Inflation expectations[1)]

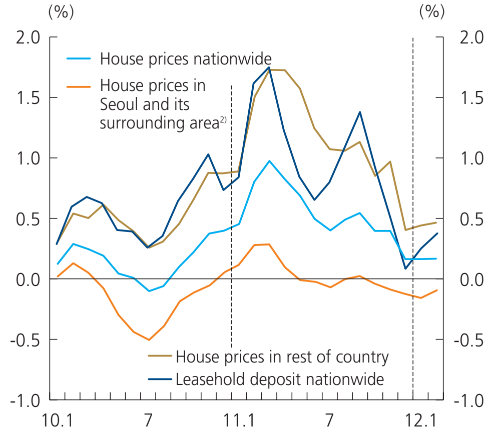


Note: 1) Survey findings as to the rate of inflation for the coming twelve months; figure for general public surveyed monthly and that for experts surveyed in the first month of every quarter.
Source: The Bank of Korea

As for house prices, in the second half of the 2011 they showed a mild downward trend in Seoul and its surrounding area, while sustaining their upward trend in the rest of the country, albeit at a somewhat lower rate.

The scale of the increase in housing leasehold deposits meanwhile widened in the third quarter, centering on those in Seoul and its surrounding area, due to a shortage of available apartments and to seasonal demand for house moving with the coming of autumn. From the beginning of the fourth quarter, their pace of increase however, slackened greatly, influenced by the burdens stemming from their steep upward trend until then.

Changes[1)] in house prices and leasehold deposits

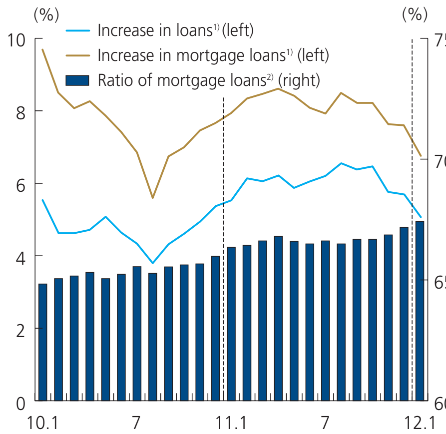


Notes: 1) Compared with the previous months.
2) Seoul, Gyeonggi, and Incheon.
Source: Kookmin Bank.

8 In the financial sector, the scale of the increase in household lending by banks declined somewhat from the third quarter of

2011, under the influence of the 'Comprehensive Measures on Household Debt (June 29, 2011)' announced by the government. Household lending by non-bank financial institutions in contrast maintained a comparatively steep upward trend, led by mutual credit unions and insurance companies. Banks' corporate lending increased steadily owing to the demand for working capital.

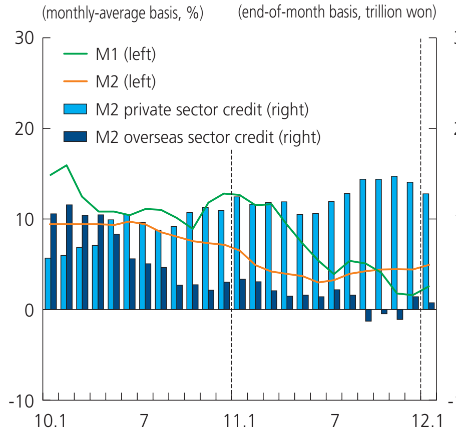
Household lending by commercial & specialized banks



Notes: 1) Compared with the same months of the previous years; end-of-month basis.
2) Ratio of mortgage loans to total household loans.
Source: The Bank of Korea.

The year-on-year rate of broad money M2 growth sustained a rising trend, from a low of 3.0% in June to a level of around 5% in February 2012, in line with the accelerated expansion of private sector credit despite the net outflows of foreign portfolio investment funds. Corporate financial conditions remained generally favorable, but from the fourth quarter presented a somewhat deteriorating picture, centering on both SMEs and marginal corporations with their poor business climate, affected by the increase in external destabilizing factors and the economic slowdowns at home and abroad.

M1[1] & M2 growth rates[2] and changes[2] in M2 private and overseas sector credit



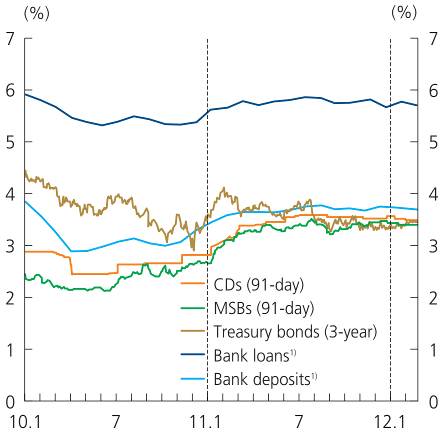
Notes: 1) Excluding MMFs.
2) Compared with the same months of the previous years.
Source: The Bank of Korea.

9 Short-term market interest rates including yields on Monetary Stabilization Bonds (91-day) halted their upward trend and exhibited no marked changes as the Bank of Korea kept the Base Rate unchanged from the second half of 2011.

Long-term market interest rates (3-year Treasury bond basis) fell back, due to the economic slowdowns in major countries and the concerns about the sovereign debt problems in Europe. They registered a low for the year of 3.31% in mid-September, and subsequently fluctuated within a narrow range of 3.3~3.6%.

Reflecting these movements in market interest rates, bank loan and deposit rates similarly exhibited relatively stable patterns of movements from the beginning of the second half.

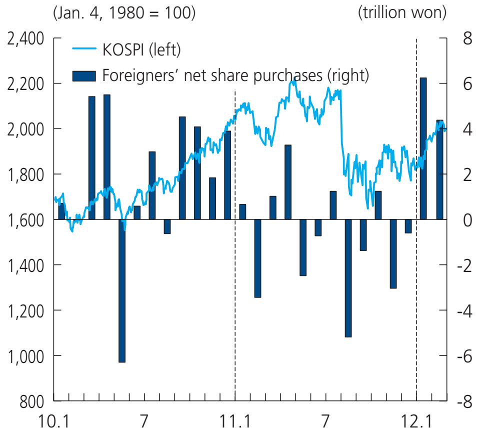
Market interest rates, and bank loan and deposit rates



Note: 1) Based on newly-handled loans and deposits; the figures for February 2012 are preliminary.
Sources: The Bank of Korea, Koscom Corp.

margin from mid-January 2012, influenced by the ECB's provision of long-term liquidity, the improvement of some US economic indicators, and the large net inflows of foreign portfolio investment funds. As of end-February this year the KOSPI stood at 2,030, lower by 3.4% than at the end of June 2011. Foreign shareholdings as a percentage of total domestic stock market capitalization declined to 30.0% as of the end of August last year, but rebounded somewhat by end-February this year to stand at 30.9%.

KOSPI and foreigners' net share purchases



Source: Koscom Corp.

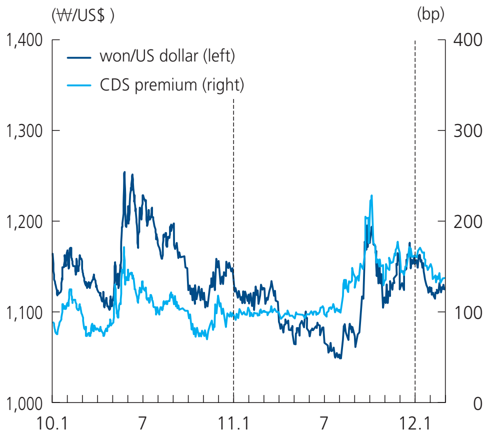
10 Share prices fell sharply from early August 2011, due to the downgrade of the US sovereign credit rating and the emergence of sovereign debt problems in Europe, but they have increased by a large

11 The Korean won/US dollar exchange rate, after falling to 1,050 won per US dollar on July 27, 2011 thanks to the continued buoyancy of exports, shifted to an upward trend from August on due to the

international financial market unrest and registered 1,196 won as of September 26. It subsequently dropped by a large margin as the fears concerning the euro area crisis eased and the bilateral Korea-Japan and Korea-China currency swap arrangements were announced, and fluctuated in response to the evolution of euro area crisis conditions. From the beginning of 2012, it dropped slightly amid the soothing of international financial market unrest, and stood at 1,119 won per the US dollar as of end-February 2012, having depreciated 4.6% compared with the end of June 2011. Meanwhile, overseas borrowing conditions worsened from August 2011 onward due to the expansion in external destabilizing factors, but has picked up somewhat since January this year with mitigation of international financial market unease. The foreign currency funding conditions of domestic banks also appeared favorable by and large, owing to their efforts to secure foreign currency liquidity in advance and to the inflows of medium- and long term funds borrowed overseas.

12 Looking at the future environment for monetary policy operations, major economic forecasting organizations anticipate that the world economy will show a mild trend of recovery. There do remain uncertainties as to the economic growth path, however, influenced by risk factors such as the sovereign debt problems in Europe and the geopolitical risks in the Middle East.

Exchange rate and CDS premium[1]



Note: 1) Foreign Exchange Stabilization Fund Bonds, 5-year maturity.
Sources: Korea Money Brokerage Corp., Seoul Money Brokerage Services Ltd., and Datavision.

Outlook for world economic growth[1]

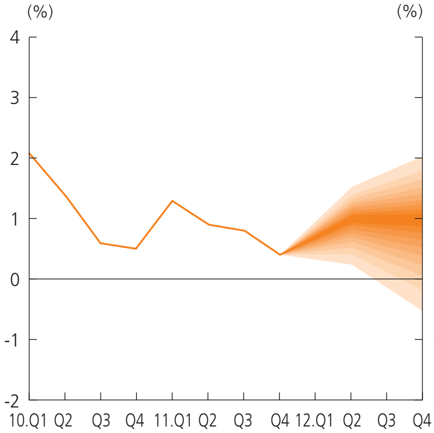
(%)

	2011[1]	2012[e]		2013[e]	
		IMF	World Bank	IMF	World Bank
World	3.8	3.3	3.4	3.9	4.0
(US)	1.7	1.8	2.2	2.2	2.4
(Japan)	-0.7	1.7	1.9	1.6	1.6
(Euro area)	1.4	-0.5	-0.3	0.8	1.1
(China)	9.2	8.2	8.4	8.8	8.3

Note: 1) Based on IMF statistics, apart from individual countries and the euro area which are based on their respective statistics.
Sources : IMF, World Economic Outlook Update, Jan. 2012
World Bank, Global Economic Prospects, Jan. 2012

Domestic economic activity is forecast to continue to show signs of slackening throughout most of the first half of 2012, being unable to attain its long-term growth trend, but to present an upward albeit modest trend in the second half as uncertainties lessen. However the downside risk factors to domestic economic growth are expected to remain heightened for some time, influenced by external risk factors.

Economic growth fan chart[1)]

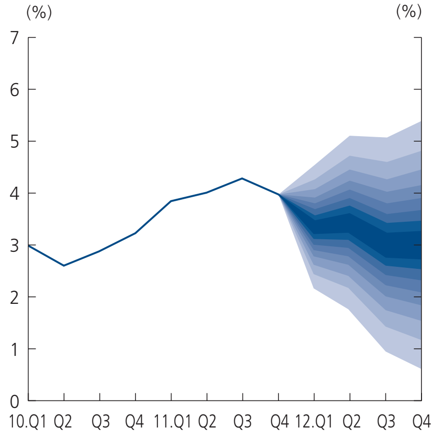


Note: 1) Compared with the previous quarters; future forecast as of December 2011.
Source: The Bank of Korea.

The consumer price inflation is forecast to retreat to a little above the 3% level, as demand side pressures ease, but inflation expectations are expected to continue running at a high level for some time. The rate of core inflation, which shows the underlying trend of prices, is forecast to exhibit a level similar to or a little higher than that of last year. Meanwhile, the potential exists for developments such as a rise in international oil prices due to the economic sanctions against Iran or abnormal weather conditions acting as supply side factors causing price instability.

In the financial markets, there is a likelihood that price variables and in- and outflows of foreign portfolio investment funds will exhibit a high degree of volatility, in line with the evolutions of external destabilizing factors.

Consumer price inflation fan chart[1)]



Note: 1) Compared with the same periods of the previous years; future forecast as of December 2011.
Source: The Bank of Korea.

13 The Bank of Korea will conduct its monetary policy so as to stabilize consumer price inflation at the midpoint of the inflation target over a medium-term horizon, amid continuing sound growth of the domestic economy. To this end the Bank will closely monitor both the downside risks

to the growth path posed by financial and economic risk factors at home and abroad, and the progress of the climate of high inflation expectations. It will reflect these factors in its policy implementation.

The Bank will strive further to enhance its monetary policy effectiveness. Policy efforts will be directed toward ensuring that the measures modified or introduced by the revision of the Bank of Korea Act (September 16, 2011) - such as the imposition of reserve requirements on some types of financial bonds, the method of managing required reserves on a monthly basis, and securities lending facility - take firm root at an early stage. To heighten the transparency and predictability of monetary policy, the Bank will also continue to strive to strengthen its policy communications. The Bank plans in addition to work to ensure the seamless supply of financial institution funds to SMEs and other fragile sectors, by way for example of improvements in its Aggregate Credit Ceiling Loans.

This is the final year of the current medium-term inflation target period (2010-2012), and the inflation target for 2013 and onward will be decided in consultation with the government.

The Bank plans to devote positive efforts toward financial stability, including by strengthening its drive to identify and address financial sector fragilities and systemic risks. The stage-by-stage comprehensive contingency plan in preparation against deterioration in financial and foreign exchange market conditions, due for example to an abrupt surge in outflows of foreign funds or to elevated geopolitical risks, will be continually reexamined and supplemented. The efforts to ensure a soft landing of the household debt problem will be continued as well, in cooperation with the government and other related organizations. The Bank will redouble its efforts to promote cooperation with major central banks and international financial institutions.

I

Economic and Financial Developments

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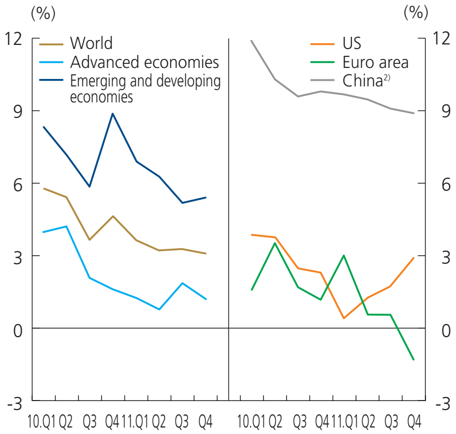
1. Global Economy

A. Economic Growth and Prices

(1) Economic Growth

In the world economy, the trend of recovery has shown signs of faltering as the negative impacts on the real economy of the continued deterioration of the sovereign debt problems in Europe during the latter half of 2011 have spread to emerging market countries. For the advanced countries, growth trends showed a mild expansion, centering on the US and Japan, in line with a return to normal in the third quarter following the temporary setbacks to production owing to the massive Japanese earthquake and the blunting of the upward trend of international oil prices. From the

<Figure I-1> **World economic growth[1]**



Notes: 1) Annualized percentage changes from the preceding quarters.
2) Compared with the same periods of the previous years.
Sources: IMF, World Economic Outlook Update, Jan. 2012; Individual countries' published statistics.

<Table I-1> **Economic growth of major economies[1]**

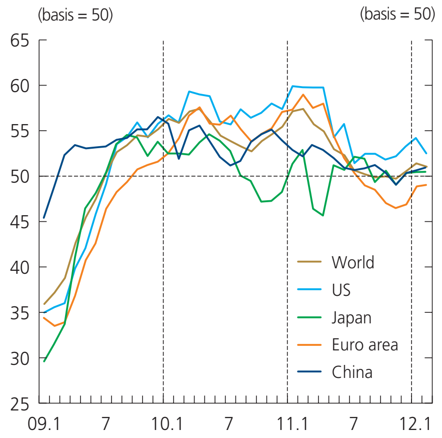
(%)

	2009	2010	2011[2]				
			Year[e]	Q1	Q2	Q3	Q4
World	-0.6	5.2	3.8	3.7	3.2	3.3	3.1
Advanced economies	-3.7	3.2	1.6	1.3	0.8	1.9	1.2
US	-3.5	3.0	1.7	0.4	1.3	1.8	3.0
Japan	-5.5	4.4	-0.7	-6.9	-1.2	7.1	-0.7
Euro area	-4.2	1.9	1.4	3.1	0.5	0.6	-1.3
Newly industrialized Asian economies[3]	-0.7	8.4	4.2	-	-	-	-
Emerging and developing economies	2.8	7.3	6.2	6.9	6.3	5.2	5.5
Asia	7.2	9.5	7.9	-	-	-	-
(China)	9.2	10.4	9.2	9.7	9.5	9.1	8.9
(India)	6.8	9.9	7.2	7.8	7.7	6.9	6.1
Latin America	-1.7	6.1	4.6	-	-	-	-
(Brazil)	-0.3	7.6	2.8	4.2	3.3	2.1	1.4

Notes: 1) Based on IMF statistics, apart from individual countries and the euro area which are based on their respective statistics.
2) The figures of the World, Advanced economies, US, Japan, euro area, and the Emerging and developing economies are annualized percentage changes from the preceding quarters, and the figures of China, India, and Brazil are compared with the same periods of the previous years.
3) Korea, Taiwan, Hong Kong, and Singapore.
Sources: IMF, World Economic Outlook Update, Jan. 2012; Individual countries' published statistics.

beginning of the fourth quarter, though, there was a weakening of the momentum of the recovery in business activity that was exemplified by negative growth rates in the euro area and Japan chiefly owing, respectively, to the sovereign debt problems and the deterioration of the export environment. The emerging market countries displayed a comparatively rapid weakening of their growth trends in response to the subdued trend of exports and the reduced growth of domestic demand. As a consequence, during the latter half of the year there was a narrowing of the gap in growth between the emerging market countries and the advanced countries.

<Figure I-2> PMI indices in manufacturing industry of major economies

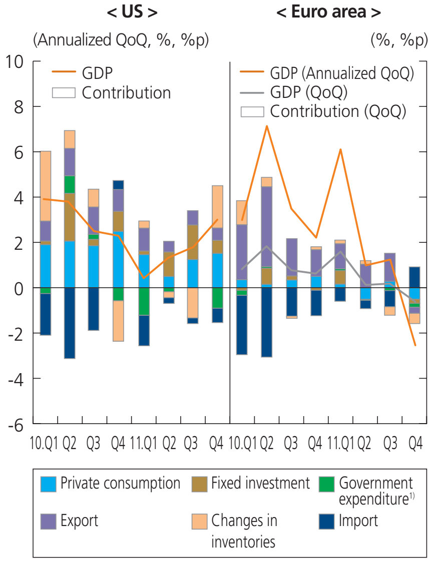


Source: Bloomberg.

The US economy gradually enlarged its recovery trend from the low ebb of the first quarter of 2011 up until the fourth quarter. From early in the latter half of the year, the constraints on production and consumption because of the massive Japanese earthquake and the run-ups in international oil prices moderated, while individual consumption expanded boosted by improved confidence, and facilities investment increased consistently, thanks to firms' improved cash flow. Nevertheless, the pace of growth moderated generally with the continuation of the contraction of government spending and of the lackluster housing market while the improvement in labor market conditions was also limited. The GDP growth (annualized quarter-on-quarter rate) picked up from 1.3% in the second quarter to 1.8% in the third quarter and then to 3.0% in the fourth quarter.

In the euro area economy, the pace of recovery slackened abruptly over the course of the latter half of the year because of the deterioration of the sovereign debt problems and financial market unrest. While the governments of most member states extended their fiscal tightening, private consumption and fixed investment were listless owing to the heightened economic uncertainties and financial institutions' tendency to avoid lending. In terms of specific countries, Greece and Portugal, which were recipients of bailout financing, remained in the economic doldrums while economic activity also contracted in Germany and the other core countries. Consequently, GDP growth (annualized quarter-on-quarter rate) just stood at 0.6% in the third quarter and fell to -1.3% in the fourth quarter.

<Figure I-3> **Contribution to economic growth in US and euro area**

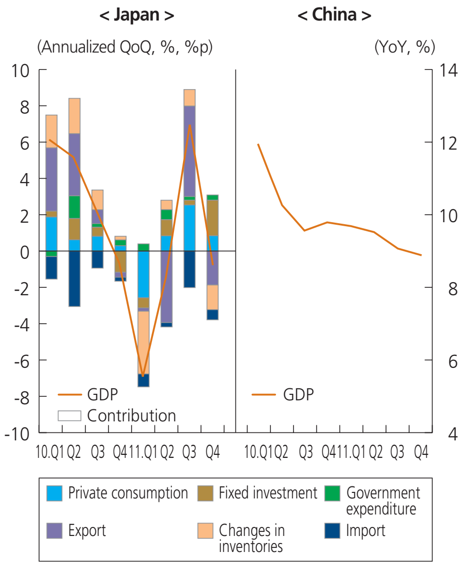


Note: 1) The figures of the US are sum of government consumption expenditures and gross investment; the figures of the euro area are government final consumption expenditures.
Sources: US Department of Commerce, Eurostat.

The Japanese economy gradually escaped from the influence of the massive earthquake from the beginning of the latter half of the year to show a short-lived recovery trend, but then took on a renewed subdued pattern, influenced by the slowing of world economic growth and a strengthening yen. In the third quarter, the constraints on supply following the massive earthquake gradually moderated and consumer sentiment recovered so that household consumption and expenditures increased while public investment expanded for the reconstruction following earthquake damage. As a net consequence, the growth rate shifted to a positive figure after being in negative territory during the first half of the year. In the fourth quarter, nevertheless, the growth rate recorded a negative figure again as global economic activity weakened and exports shrank because of the strong yen while electronic products, transport equipment, and the like suffered production setbacks because of severe flooding in Thailand.

The Chinese economy, similarly, presented a somewhat more subdued pattern of growth during the latter half of 2011 than in the first half of the year, even though the growth rate still remained high. Private consumption maintained its rapid rate of increase against the backdrop of rising wages and investment, similarly, maintained a rapidly increasing trend, helped by the large-scale construction of public housing for the less affluent. The scale of the increase in exports narrowed, however, affected by the slackening of business activity in the euro area and the appreciation of the Chinese yuan. Consequently, the GDP growth rate (year-on-year), which had hovered around 9.5% in the first half year, gradually slipped to 9.1% in the third quarter and to 8.9% in the fourth quarter.

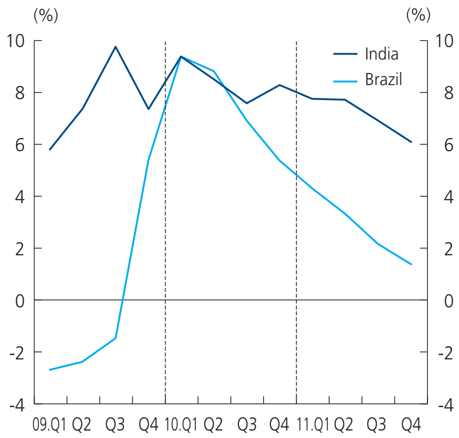
<Figure I-4> Contribution to economic growth in Japan and China[1]



Note: 1) Chinese real GDP statistics are not released broken down by component of expenditure.
Sources: Cabinet Office of Japan, National Bureau of Statistics of China.

The economies of the other major emerging market countries also exhibited a weakening pattern of growth from the beginning of the latter half of the year. India's GDP growth rate (year-on-year) dropped from a little under 8% in the first half of the year to 6.1% in the fourth quarter on the slowing of capital inflows and monetary tightening, while that of Brazil fell from 3.3% in the second quarter to 2.1% in the third quarter and to just 1.4% in the fourth quarter, in keeping with the slackening of the growth of exports such as those of raw materials because of the weakening of global business activity.

<Figure I-5> Economic growth in India and Brazil[1]



Note: 1) Compared with the same periods of the previous years.
Sources: Individual countries' published statistics.

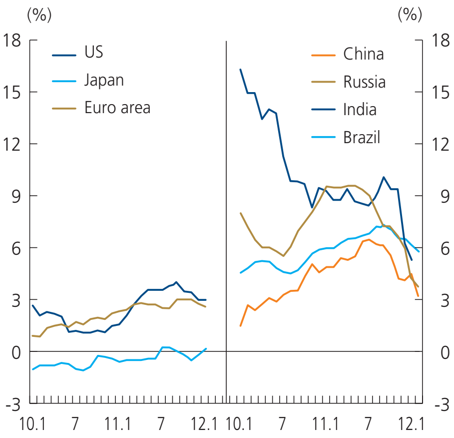
(2) Prices

The upward trend of global inflation flattened out from the beginning of the latter half of the year, thanks to the stabilization of international commodity prices and the easing of demand side pressures in line with the world economic slowdown. High inflation expectations and a renewed rise of international oil prices, due to geopolitical risk in the Middle East, nevertheless have remained as potentially destabilizing factors to prices. In the advanced countries, while demand-side pressures did not loom large with GDP running below its potential level, prices reacted sensitively chiefly to the fluctuations of energy prices. In several countries, the raising of indirect taxes and increases in public charges served as factors putting upward pressure on prices. In the emerging market countries, the ups and downs of food prices exercised a large influence on overall price movements and the waning of demand-side pressures due to monetary tightening measures acted as a factor in slowing the upward pace of prices.

US consumer prices accelerated their pace of increase (year-on-year) to 3.9% in September 2011, mainly driven by cost-side factors including prices of energy and food; subsequently, helped by the stability of international oil prices, their pace slipped back to 2.9% in January 2012. Consumer price inflation in the euro area continued to run above the European Central Bank's target during the latter half of 2011, influenced by the high level of international commodity prices, the weak tone of the euro, and increases in indirect taxes: after rising to 3.0% in the three months from September-November 2011, the upward pace slowed somewhat and then dropped back to 2.6% in January 2012. Meanwhile, in Japan, the CPI inflation (year-on-year), which had remained constantly in negative territory because of persistent imbalances between supply and demand within the economy as a whole, turned briefly positive (0.2%) during July and August, mainly in response to the rise of cigarette and gasoline prices and of electricity tariffs. It then turned negative once again from October onwards, influenced by the reduction in the prices of items associated with household appliances, whose sales were lackluster.

Among the emerging economies, the rate of increase in Chinese consumer prices (year-on-year) rose to 6.5% in July 2011, its highest level for 36 months, with the widening scale of increases in the prices of meat and other foodstuffs, but then fell back to the 3.2% level this February with the blunted upward trend of food prices, the time-lagged effect of the increases in the policy rate and reserve requirement ratios, and the influence of restrictions on lending to sectors where activity was overheated. Russian consumer price inflation (year-on-year) maintained a high rate of above 9% during the first half of 2011, but moderated markedly during the latter half of the year owing to the increased production of agricultural products, and then dropped to 3.7% in February this year. For India, despite aggressive monetary tightening measures (policy-rate hikes on seven occasions in 2011), the rate of consumer price increases (year-on-year) maintained a high level of 9%, owing to the increase in import prices generated by the sharp fall in the exchange value of the rupee from August onwards and the continued upswing in the prices of food and petroleum-based fuel, but it then dropped to the 5% level in January 2012. In Brazil, the scale of the increase in prices narrowed consistently, thanks to the stability of international commodity prices and the defusing of demand-side pressures caused by the slackening of domestic demand, so that the rate of increase in consumer prices registered 3.7% (year-on-year) in February 2012.

<Figure I-6> **CPI inflation in major economies[1)]**



Note: 1) Compared with the same months of the previous years.
Sources: Individual countries' published statistics, Eurostat.

B. International Financial Markets

The international financial markets exhibited a highly unstable pattern from August 2011 onwards owing to the downgrade of the US sovereign credit rating and the worsening of the sovereign debt problems in Europe. Share prices and long-term interest rates plunged together, and credit spreads widened, in line with a heightened preference for safe-haven assets and the strengthening of financial institutions' efforts to secure liquidity. The market unrest gradually eased from late December, however, thanks to the ECB's large-scale provision of long-term liquidity.

(1) Short-Term Market Interest Rates

Looking at short-term market interest rates in the major countries, those in the US and Japan remained by and large at low levels throughout the latter half of 2011, owing, inter alia, to the continuation of an accommodative monetary policy stance. US short-term market rates, nevertheless, did rise somewhat as banks' credit risk was accentuated owing to the worsening of the sovereign debt problems in Europe. Within the euro area, short-term market interest rates marked a downward trend following the ECB's reduction of its policy rate.

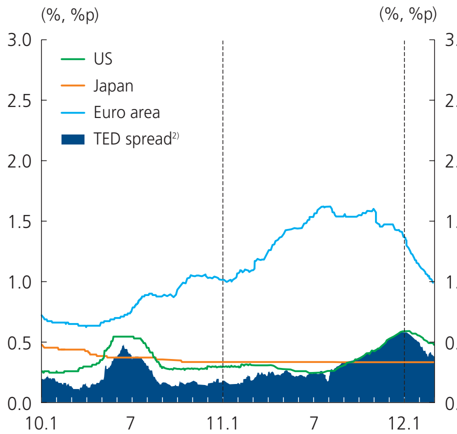
US short-term market interest rates rose gently during the latter half of 2011, because of wariness about lending within the interbank market prompted by the heightened credit risk of European banks. From early 2012, though, they eased slightly following the announcement[1] by the Federal Reserve of its intentions regarding lengthening the period for keeping the policy rate near zero together with a mild amelioration of credit risk. As of the end of February 2012, LIBOR (3-month) stood at 0.48%, 0.23 percentage points higher than its 0.25% at the end of June 2011. The Ted spread (3-month, LIBOR minus T-bill rate), an indicator of credit risk in the short-term financial markets, widened up until year-end 2011, but exhibited narrowing movements from early this year.

TIBOR (3-month), the Japanese short-term market interest rate, remained at a low level in the environment formed by around zero of the Bank of Japan's interest rate and quantitative easing policies.

1) The US Federal Reserve changed the planned ending of the period for holding the policy rate at its level (0-0.25%) from the previous 'at least through mid-2013' to 'at least through late 2014' in January 2012.

Euro area short-term market interest rates adhered to a comparatively high level because of the ECB's upward adjustment of its policy rate in July 2011 and the deterioration of European banks' short-term liquidity conditions, but subsequently exhibited a downward trend as the ECB twice cut its policy rate by 25 basis points respectively, in November and again in December, and supplied banks with 3-year liquidity amounting to 489.2 billion euro (December 21). As of the end of February 2012, EURIBOR (3-month) stood at 0.98%, which was 0.56 percentage points lower than at the end of June 2011.

<Figure I-7> **Short-term market interest rates in major economies[1)]**



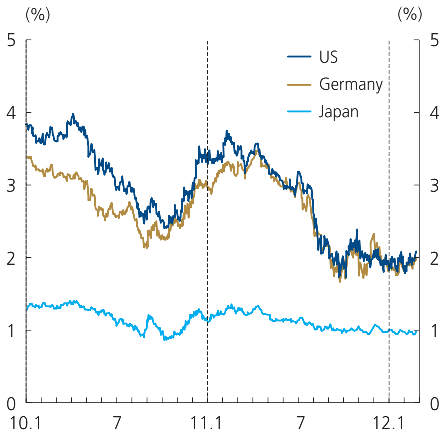
Notes: 1) On the basis of 3-month LIBOR in the US, 3-month EURIBOR in the euro area, and 3-month TIBOR in Japan.
2) 3-month LIBOR minus T-bill rate.
Source: Bloomberg.

(2) Long-Term Market Interest Rates

Long-term market interest rates (secondary market yields on 10-year Treasury bonds) in major countries fluctuated at a low level after having fallen back rapidly from early in the latter half of 2011 on fears of a slowdown in major countries' economic activity and in response to a preference for safe-haven assets amid the financial market turmoil.

US long-term market interest rates fell to their lowest-ever level in response to the downgrade of the US sovereign credit rating by S&P (August 5, 2011), concerns about the weakening of the economic recovery, the announcement (September 21) of the

<Figure I-8> **Long-term market interest rates in major economies[1)]**



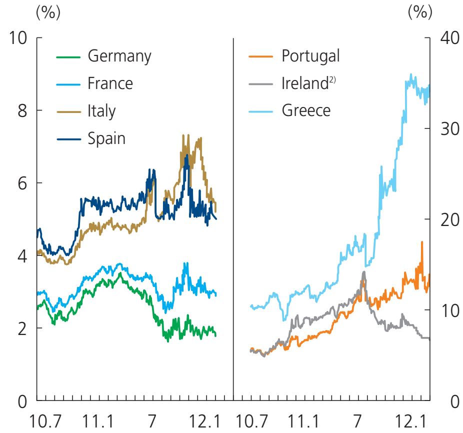
Note: 1) Based on each country's 10-year Treasury bond yields.
Source: Bloomberg.

Federal Reserve's Operation Twist[2], and signs of the spread of the sovereign debt problems in Europe. Long-term rates subsequently fluctuated in accordance with improved US economic indicators and short-lived phases of amelioration or deterioration of the sovereign debt problems in Europe. As of the end of February 2012, they registered 1.97%, which was 1.19 percentage points lower than their 3.16% at the end of June 2011. Japanese long-term market interest rates continued on a stable downward trend, registering 0.96% as of the end of February 2012, which was 0.18 percentage points lower than at the end of June 2011.

Euro area long-term market interest rates showed disparate movements in line with the differing sovereign debt situation from country to country. German long-term market interest rates marked a pattern of fluctuations after having fallen back sharply because of the heightened preference for safe-haven assets during the months of August and September 2011; French long-term market interest rates exhibited wide fluctuations at a somewhat higher level than German rates; those in Italy and Spain climbed until mid-December to reach post-EMU highs amid an escalation of fears on the spread of the sovereign debt problems following the downgrade of their sovereign credit ratings, but they subsequently fell back upon the ECB's provision of long-term liquidity. Greek and Portuguese long-term market interest rates, meanwhile, held to a steeply upward trend until the end of the year, as there were continued fears about national default. From early this year, they eased somewhat. German long-term market interest rates stood at 1.82% as of end-February 2012, which was 1.21 percentage points lower than at the end of June 2011.

In terms of individual country credit risk,

<Figure I-9> Long-term market interest rates in major euro area countries[1]



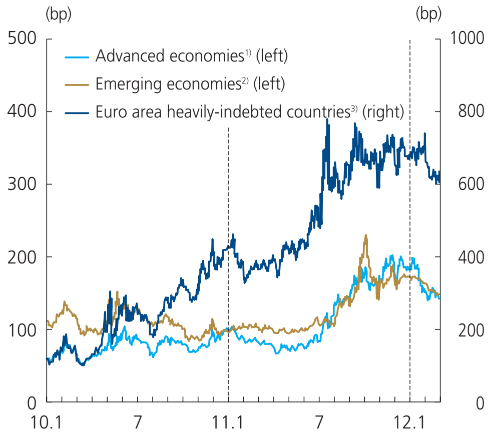
Notes: 1) Based on each country's 10-year Treasury bond yields.
2) Based on Ireland's 9-year Treasury bond yields after Oct. 12, 2011.
Source: Bloomberg.

2) This brought about a fall of long-term interest rates through the purchase of long-term Treasury bonds in exchange for the sale of short-term Treasury bonds on a scale of $400 billion up until June 2012.

the CDS premiums for heavily-indebted European countries (other than Greece) increased sharply amid the heightened possibility of the spread of the sovereign debt problems in Europe, but exhibited a declining pattern from February 2012[3].

In the case of the emerging market countries, the CDS premiums rose sharply in August and September 2011 amid fears of a worsening of financial institutions' foreign currency funding conditions in line with the European financial market turmoil, but they subsequently followed a stable pattern of movements.

<Figure I-10> **Sovereign CDS premiums**



Notes: 1) G7 country (excluding Canada) average.
2) BRICs (excluding India) and five Asian emerging country average.
3) Portugal, Ireland, Italy, and Spain average.
Source: Bloomberg.

(3) Share Prices

Global share prices fell back steeply from August 2011 in response to the downgrade of the US sovereign credit rating, the spread of the sovereign debt problems in Europe, and concerns about the global economic slowdown; and they subsequently exhibited a pattern of wide fluctuations. From early 2012, though, they shifted to an upward trend as the mood of market unease was soothed to some degree by anticipations of a resolution of the sovereign debt problems.

<Figure I-11> **Advanced and emerging economy share price indices**

Source: Bloomberg.

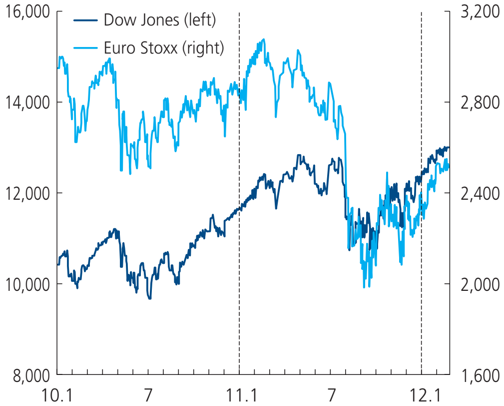
US share prices dropped sharply from August 2011 onwards as risk aversion heightened because of the backdrop of the downgrade of the sovereign credit rating,

3) In the case of Greece, however, the CDS premium had risen to stand at 19,963 basis points as of the end of February 2012 in accordance with the elevated likelihood of a credit event occurring because of the promotion of debt adjustment involving private sector government bond holdings (private sector involvement, PSI).

fears of the weakening of the economic recovery trend, and the intensified global financial market unrest. From October, nevertheless, they exhibited a robust upward trend, boosted by improved economic indicators and favorable corporate performance. As a net consequence, as of the end of February 2012 the Dow Jones Industrial Average had risen by 4.3% from its level at the end of June 2011 to stand at 12,952.1.

Euro area share prices followed a similar pattern of movements to those in the US, but the depth of their fall during August and September 2011 was greater whereas their subsequent upward trend was only mild. Share prices plunged in August upon signs of the spread of the sovereign debt problems to countries such as Italy and Spain and European banks' increased liquidity risk. They then continued a weak tone as fears of an economic recession mounted. Nevertheless, from the last week or so of December, they shifted to an upward trend, although within a limited scale, upon the ECB's provision of long-term liquidity. As of the end of February 2012, the Euro Stoxx Index stood at 2,512.2, having shed 11.8% from its level at the end of June 2011.

<Figure I-12> US and euro area share price indices[1]

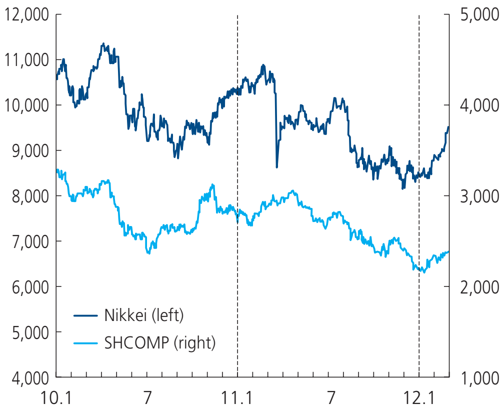


Note: 1) On the basis of closing prices.
Source: Bloomberg.

Japanese share prices exhibited a precipitate downward trend during the latter half of 2011 because of the slowdown of global economic activity and the deterioration of export conditions in accordance with the continued strength of the yen. They subsequently rebounded from early 2012, boosted by the easing of global financial unrest and the yen's shift to a weakening trend. The Nikkei stood at 9,723.2 as of end-February 2012, lower by 0.9% than at the end of June 2011.

Chinese share prices continued on a downward trend during the latter half of 2011 in response to the steep fall of global share prices, the deceleration of export growth, and outflows of foreigners' equity investment funds, but they rallied from the beginning of 2012, thanks to anticipations of some easing of the monetary policy stance and better-than-expected economic growth in the fourth quarter of the previous year. As of the end of February 2012, the Shanghai Composite Index stood at 2,428.5, having fallen by 12.1% compared with the end of June, 2011.

<Figure I-13> **Japan and China share price indices[1]**



Note: 1) On the basis of closing prices.
Source: Bloomberg.

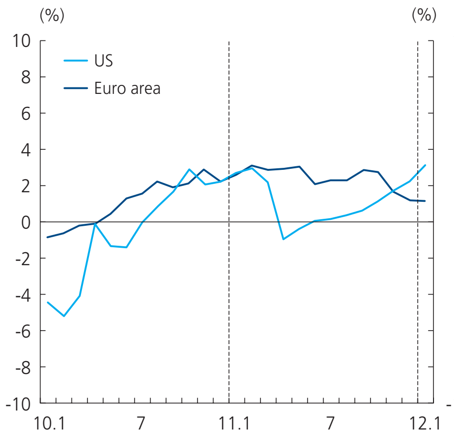
(4) Bank Lending

In regard to the trends of credit provision by financial institutions in major advanced countries, those in the US and the euro area exhibited different patterns. Bank lending in the US increased consistently from June 2011 onwards because of the consolidation of the economic recovery trend and the continuation of the accommodative monetary policy stance, whereas that in the euro area slowed from October onwards because of the avoidance of risky loans.

In the case of the US, the rate of increase in bank lending turned positive from June onwards as banks' attitude toward lending became less rigid, encouraged by their improved asset soundness, in addition to which there was increased household and corporate demand for funds because of the economic recovery, good corporate performance, and the expansion of facilities investment ahead of the ending of tax advantages related to investment at the year-end.

In the euro area, the increasing trend of bank lending slowed rapidly, particularly for household loans, as banks experiencing

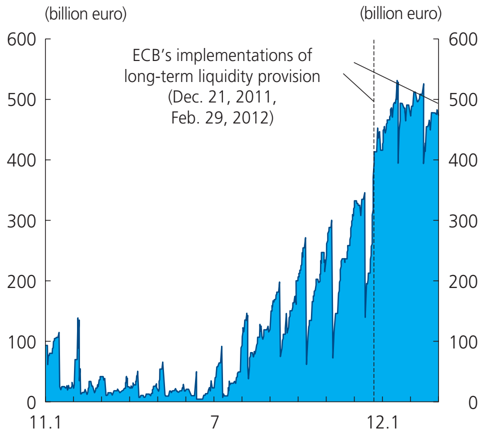
<Figure I-14> **Growth of US and euro area bank lending[1)2)]**



Notes: 1) Compared with the same months of the previous years.
2) The figures of the US are on the basis of lending by commercial banks; the figures of the euro area are on the basis of household and corporate lending by monetary financial institutions.
Sources: US Federal Reserve, ECB.

fund-raising difficulties because of the spread of the sovereign debt problems showed a tendency to avoid lending. The total amount of bank funds on deposit with the ECB rose steeply to 475.2 billion euro[4] as of the end of February 2012 as against the 251.4 billion euro just before the ECB's provision of long-term liquidity at the end of December. Seen in this light, the considerable amount of long-term liquidity supplied by the ECB is not seen as having been sufficiently employed for lending or the purchase of government bonds.

<Figure I-15> **Euro area bank funds on deposit with the ECB**



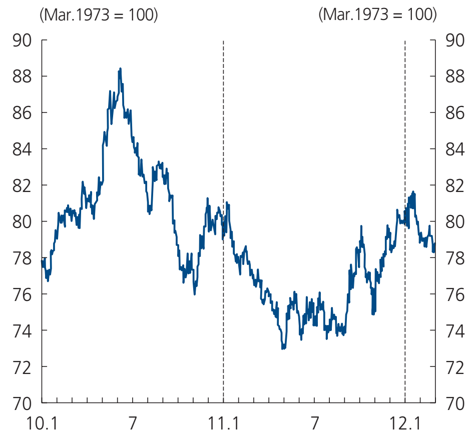
Source: ECB.

(5) Exchange Rates

The US dollar exhibited a strengthening trend against most other major currencies including the euro from the beginning of the latter half of 2011 owing to the heightened preference for safe-haven asset but from mid-January 2012, it shifted to a weakening trend. Meanwhile, after having weakened throughout this period against the Japanese yen, it shifted to a strengthening trend from early February, influenced by the announcement of a shift into the Japanese trade account deficit and by the Bank of Japan's introduction of the price stability goal in the medium to long term.

Against the euro, the US dollar maintained a strong tone that was attributable to the ECB policy rate reductions, the economic slowdown in the euro area, and S&P's downward adjustment of the sovereign credit rating of several euro

<Figure I-16> **US dollar index**



Source: Bloomberg.

4) After a second round of long-term liquidity provision on February 29, 2012, euro area bank funds on deposit with the ECB increased to 776.9 billion euro.

area member states; consequently by January 16 this year the US dollar had appreciated against the euro to change hands at 1.27 dollars per euro. Subsequently, it lost ground slightly amid anticipations of a resolution of the sovereign debt problems in Europe, and an announcement by the US Federal Reserve on lengthening the period of keeping its policy rate near zero. As of the end of February 2012, the US dollar traded at 1.33 per euro, representing an appreciation of its exchange value by 8.9% compared with the end of June 2011.

Against the Japanese yen, the US dollar's softening tone was further accentuated until the end of January 2012. The yen/dollar exchange rate fell to around 77 yen per dollar, and subsequently fluctuated around this level because of the heightened demand for the Japanese yen as a safe-haven currency[5] amid increased global financial market uncertainty, which limited the effects of the Japanese government's foreign exchange market intervention[6] in its concern over the weakening of export competitiveness. From early February 2012, though, the US dollar shifted abruptly to a strengthening trend against the yen under the influence of the announcements of a shift into the Japanese trade account deficit for 2011[7], and the Bank of Japan's introduction of the price stability goal in the medium to long term and additional quantitative easing policies[8]. In consequence, as of the end of February 2012, the

<Figure I-17> Major exchange rates[1)]

Note: 1) US$/€ is based on the New York market, and ¥/US$ is based on the Tokyo market.
Source: Reuters.

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5) Even though the Japanese national debt ratio (to GDP) is the highest among advanced countries, that the Japanese yen is appraised as a safe-haven asset is largely attributable to the strong debt tolerance of the Japanese economy because of the world's largest scale of net external claims and domestic residents' holdings of most of outstanding government bonds.

6) The Japanese government announced that it had undertaken unilateral intervention operations on six occasions during the latter half of 2011 involving the sale of Japanese yen to a total value of 13.6 trillion yen.

7) The Japanese balance of trade for 2011 shifted into deficit for the first time in 31 years as exports declined owing to production setbacks because of natural disasters, the global economic slowdown, and the strong yen whereas imports rose on a large scale, led by those of fuel for thermal power generation.

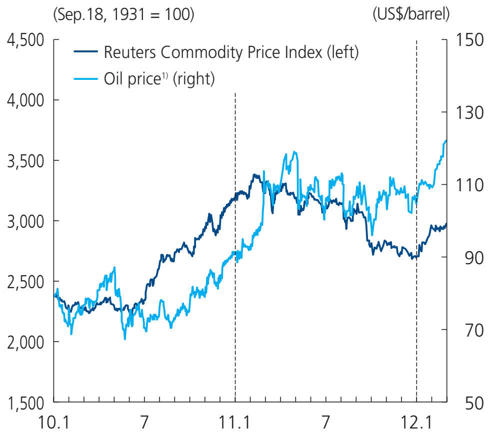
8) The Bank of Japan on February 14, 2012 announced its intention to expand the 'Asset Purchase Program' from its existing 55 trillion yen to 65 trillion yen and make use of that increase for the purchase of long-term government bonds. In addition, it unveiled the price stability goal in the medium- to long-term to be in a positive range of 2 percent or lower (year-on-year rate of change) in the consumer price index (1% for the time being) and, until achieving this goal, decided to keep the policy rate near zero and to implement highly accommodative monetary policies.

yen/dollar exchange rate stood at 80.5 yen to the dollar, which represented an appreciation of its exchange value by 0.1% for the US dollar against the Japanese yen compared with at the end of June 2011.

C. International Commodity Prices

International oil prices (Dubai crude basis, per barrel), after having climbed to 117 dollars in early April 2011, gradually dropped back until October owing to the global economic slowdown, the strength of the US dollar, and reduced inflows of investment funds into the crude oil trading market. But following the report of the International Atomic Energy Authority (IAEA) on Iran's nuclear development in November, as the conflict between the Western powers and Iran intensified and tensions became even more acute[9] with the imposition of sanctions by the Western powers against Iran in early 2012, international oil prices surged again to reach the 110 dollar level. As of the end of February 2012, the international oil price stood at 120.5 dollars, having risen 13.3% compared with the end of June 2011.

<Figure I-18> **Oil and other commodity prices**



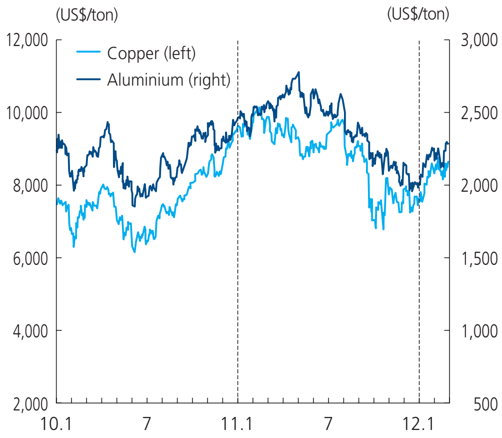
Note: 1) Based on the Dubai crude oil price.
Sources: Bloomberg, Reuters.

Other international commodity prices (Reuters Commodity Price Index basis) followed a steeply downward trend from May 2011 onwards which was largely attributable, inter alia, to the reduced inflow of investment funds owing to the strength of the US dollar, the reduced demand for non-ferrous metals on the part of the newly emerging countries, and the improved supply-demand conjuncture for grains following better weather conditions and Russia's lifting of its ban on grain exports (July 1). From early 2012, however, other international commodity prices shifted to an

9) The conflict worsened even further following the passage of a bill in the United States which prohibited financial transactions with Iran (National Defense Authorization Act) and the agreement among the euro area member states which imposed a ban on imports of oil from Iran.

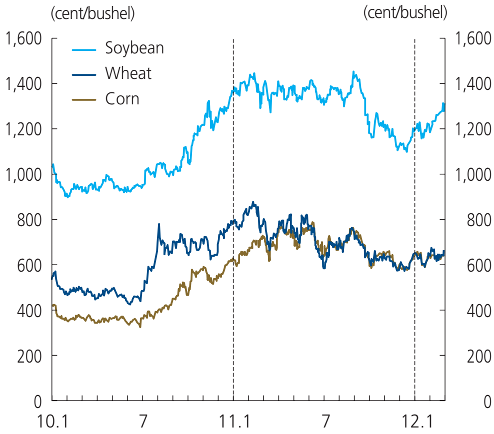
upward trend centering on non-ferrous metals such as copper and aluminium, led by heightened demand for stockpile-building in China and a shift to the weak trend of the US dollar. As of the end of February 2012, the Reuters Commodity Price Index had dropped 5.4% compared with the end of June 2011 to stand at 2,970.8.

<Figure I-19> International nonferrous metal prices



Source: Bloomberg.

<Figure I-20> International grain prices



Source: Bloomberg.

2. Domestic Economy

A. Real Economy

(1) Economic Growth

Looking at the domestic economy, its trend of growth showed signs of slowdown in the second half of 2011, amid the mounting uncertainties as to external conditions including the sovereign debt problems in Europe. Real GDP growth (quarter-on-quarter), after running at 0.8% (3.6% year-on-year) in the third quarter, fell to 0.3% (3.3% year-on-year) in the fourth quarter, as exports and domestic demand declined owing to the slowdown of world economic growth and contractions of consumer and investment sentiment. Economic activity remained subdued from early 2012, as well.

Real gross national income (GNI) showed signs of an easing of its stagnation in the first half of the year, increasing 1.0% in the fourth quarter thanks to the reduced scale of the real trade loss and the increase in real net factor income from the rest of the world.

(a) Demand

In terms of the components of demand, private consumption registered negative growth for the first time since the first quarter of 2009, shifting from a third quarter increase of 0.2% (2.1% year-on-year) to a decrease of 0.4% in the fourth quarter of 2011 (1.1% increase year-on-year) under the combined impact of weakened

<Table I-2> **Major economic growth indicators**[1)]

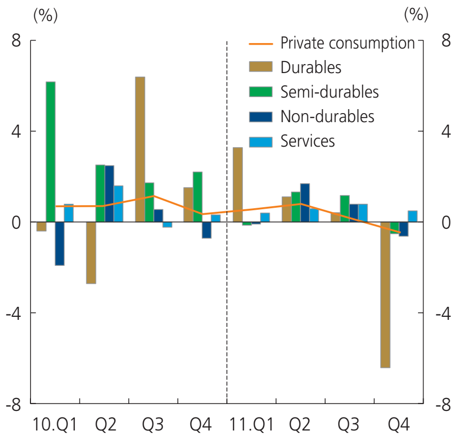
(%)

	2009	2010	2011				
			Year	Q1	Q2	Q3	Q4
Real GDP	0.3	6.3	3.6	1.3 (4.2)	0.8 (3.5)	0.8 (3.6)	0.3 (3.3)
(Private consumption)	0.0	4.4	2.3	0.6 (2.9)	0.8 (3.0)	0.2 (2.1)	-0.4 (1.1)
(Facilities investment)	-9.8	25.7	3.7	-1.6 (10.3)	4.7 (7.7)	-1.8 (1.2)	-4.3 (-3.3)
(Construction investment)	3.4	-3.7	-5.0	-4.4 (-11.0)	3.5 (-4.2)	-0.5 (-4.0)	0.1 (-2.1)
(Goods exports)	-0.2	16.0	10.5	4.1 (18.6)	0.4 (10.9)	2.1 (10.3)	-2.7 (3.8)
(Goods imports)	-7.8	18.4	8.7	3.2 (13.8)	2.7 (10.0)	1.4 (8.0)	-3.6 (3.5)
Real GNI	1.6	5.6	1.5	0.0 (1.9)	0.7 (0.6)	0.6 (1.2)	1.0 (2.2)

Note: 1) Compared with the previous periods; figures in parentheses are non-seasonally adjusted year-on-year rates.
Source: The Bank of Korea.

consumer sentiment because of the increased external uncertainties, the curbs on real purchasing power owing to the deterioration of the terms of trade and rising prices, and the increased debt service burden of principal and interest repayments because of the accumulation of household debt. By type, the consumption of goods and other durables turned extremely lackluster, declining during the fourth quarter.

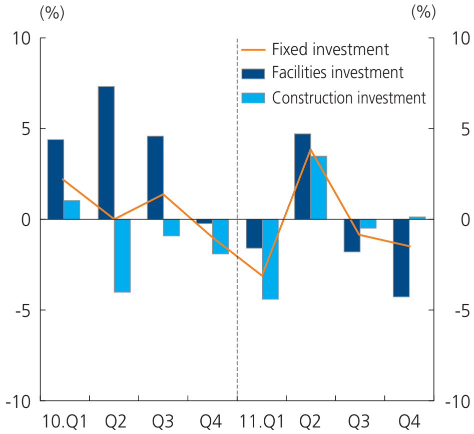
<Figure I-21> **Major consumption indicators**[1)]



Note: 1) Compared with the previous quarters.
Source: The Bank of Korea.

Facilities investment shrank 1.8% quarter-on-quarter (1.2% increase year-on-year) in the third quarter owing to depressed machinery investment, including that in semiconductor manufacturing equipment. The scale of its contraction widened in the fourth quarter to 4.3% quarter-on-quarter (3.3% year-on-year) amid the heightened external uncertainties. Construction investment, largely tracking the movements of the residential building construction, declined 0.5% quarter-on-quarter (4.0% year-on-year) in the third quarter, but then, rose 0.1% (2.1% reduction year-on-year) in the fourth quarter.

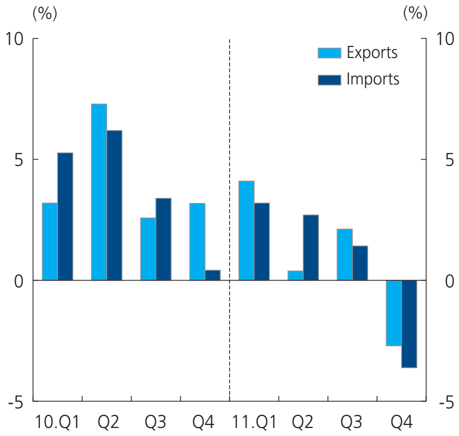
<Figure I-22> **Major investment indicators**[1)]



Note: 1) Compared with the previous quarters.
Source: The Bank of Korea.

Exports (goods) expanded 2.1% quarter-on-quarter (10.3% year-on-year) in the third quarter led by automobiles and metal products, but in the fourth quarter they declined 2.7% (3.8% increase year-on-year), with wireless communications equipment and ship building in the doldrums. Imports (goods) increased 1.4% quarter-on-quarter (8.0% year-on-year) in the third quarter, spearheaded by crude oil and natural gas, but shrank 3.6% (3.5% increase year-on-year) in the fourth quarter in a movement led by metal products and machinery.

<Figure I-23> **Growth[1] of goods exports and imports**



Note: 1) Compared with the previous quarters.
Source: The Bank of Korea.

(b) Production Activities

Manufacturing production increased 1.1% quarter-on-quarter (6.3% year-on-year) in the third quarter led by metal products and transport equipment, but in the fourth quarter it declined 0.3% (increase of 5.4% year-on-year) owing to the stagnancy of machinery and transport equipment. The average manufacturing capacity utilization ratio showed a downward pattern, slipping from 79.6% in the third quarter to 78.1% in the fourth quarter. In January this year, it picked up slightly to stand at 80.6%.

<Table I-3> **Average manufacturing capacity utilization ratio**

(%)

2010	2011					2012
	Year[p]	Q1	Q2	Q3	Q4[p]	Jan.[p]
80.9	80.0	82.2	79.9	79.6	78.1	80.6

Source: Statistics Korea.

Service sector output increased only 0.4% quarter-on-quarter (2.6% year-on-year) owing to the sluggishness of the real estate and renting and the educational services sectors. In the fourth quarter it exhibited a pattern of mild recovery, increasing 0.7% quarter-on-quarter (2.5% year-on-year), led by the wholesale and retail trade, restaurant and hotels, and finance and insurance sectors.

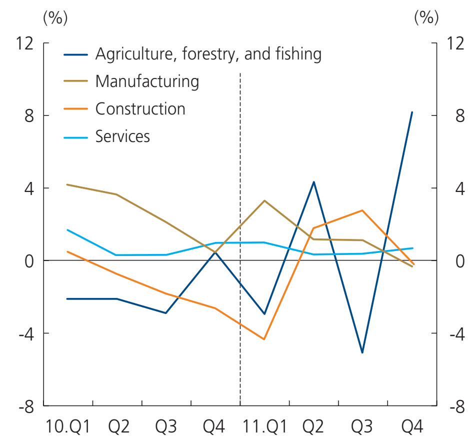
Construction increased 2.8% quarter-on-quarter (2.7% decrease year-on-year) in the third quarter focused on civil engineering and building construction, but in the fourth quarter it shrank 0.2% (0.6% year-on-year) influenced by the lackluster performance of the residential building construction. Agriculture, forestry, and fishing sector production declined 5.2% quarter-on-quarter (4.1% year-on-year) in the third quarter because of the poor showing of cultivation owing to concentrated heavy rainfall in the third quarter, though this shifted to an increase of 8.2% (3.7% year-on-year) in the fourth quarter, helped by favorable weather conditions.

(2) Employment and Wages

(a) Employment

Labor market conditions showed improvement with a rise in the number of persons employed that was centered on the private sector and a decline in the unemployment rate. The number of persons employed rose by 363 thousand year-on-year in the third quarter of 2011 and by 474 thousand in the fourth quarter, registering a year-on-year increase for the year as a whole of 415 thousand persons, the largest in scale since 2004. In January and February this year the improving trend continued with a year-on-year rise of 491 thousand persons. The labor force participation rate (seasonally-adjusted) registered 61.0% in the third quarter and 61.1% in the fourth quarter, bolstered by the increase in the number of persons employed.

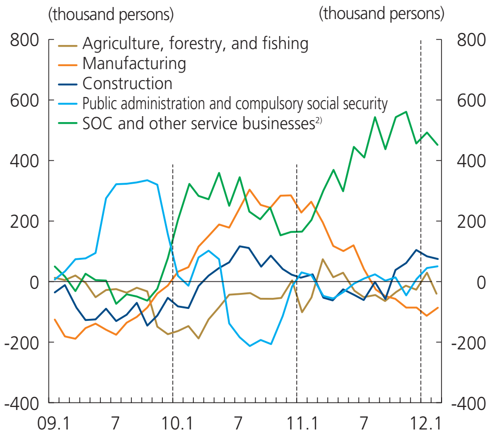
<Figure I-24> Growth[1] by major industry



Note: 1) Compared with the previous quarters.
Source: The Bank of Korea.

Looking at employment by industry, the number of persons employed in manufacturing exhibited a declining trend, but service sector employment increased by 472 thousand persons year-on-year in the third quarter of 2011 and by 514 thousand persons in the fourth quarter, led by the health and social welfare and business support services sectors. Construction employment exhibited a downward trend during the year but shifted to register an increase of 71 thousand persons in the fourth quarter. In the case of agriculture, forestry, and fishing employment, the

<Figure I-25> Changes[1] in the number of employed persons by industry

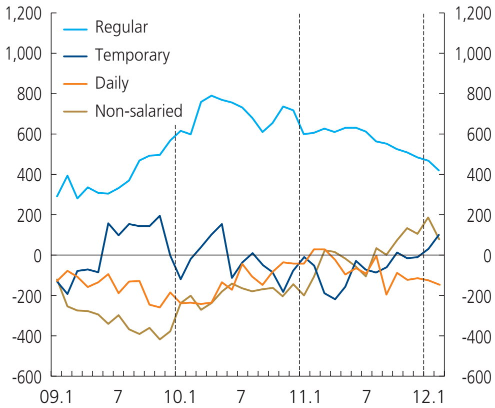


Notes: 1) Compared with the same periods of the previous years.
2) Excludes construction, public administration and compulsory social security.
Source: Statistics Korea.

number of persons employed followed a declining trend and then, from the beginning of 2012, it shifted to a year-on-year increase that was attributable to a base effect from its large-scale contraction a year earlier in response to outbreaks of foot and mouth disease.

By employment status, the number of waged employees increased by 392 thousand persons year-on-year in the third quarter and by 374 thousand persons in the fourth quarter as temporary employment shrank but regular employment expanded greatly. In non-waged employment, with the restructuring of sole trading businesses as part of the government's policy of enhancing domestic demand, the scale of the decline in employment narrowed in the third quarter and then it shifted to record a substantial increase of 100 thousand persons in the fourth quarter. Meanwhile, in terms of age group, the number of persons employed aged 50-60 rose on a large scale, leading the overall increase in employment.

<Figure I-26> Changes[1] in the number of employed persons by employment status



Note: 1) Compared with the same periods of the previous years.
Source: Statistics Korea.

<Table I-4> Major employment-related indicators

(million persons, %)

	2010	2011					2012
		Year	Q1	Q2	Q3	Q4	Jan.~Feb.
Economically active population	24.8	25.1	24.5	25.4	25.3	25.2	24.7
(Rate of growth)[1]	1.5	1.4	1.3	1.6	1.1	1.6	1.8
Economic participation rate[2]	61.0	61.1	61.1	61.2	61.0	61.1	61.4
Number of employed persons	23.8	24.2	23.5	24.6	24.5	24.5	23.8
(Changes)[1]	0.3	0.4	0.4	0.4	0.4	0.5	0.5
Number of unemployed persons[2]	0.92	0.85	0.96	0.86	0.80	0.78	0.88
(Non-S.A.)	0.92	0.85	1.03	0.86	0.79	0.74	0.95
Unemployment rate[2]	3.7	3.4	3.9	3.4	3.2	3.1	3.5
(Non-S.A.)	3.7	3.4	4.2	3.4	3.1	2.9	3.9
Economically non-active population	15.8	16.0	16.4	15.6	15.9	16.0	16.6
(Rate of growth)[1]	0.9	0.7	0.8	0.4	1.2	0.3	0.3

Notes: 1) Compared with the same periods of the previous years. 2) Seasonally adjusted.
Source: Statistics Korea.

(b) **Wages**

The all-industry nominal wage (based on businesses employing at least five regular workers) rose by 0.6% year-on-year in the third quarter and by 1.5% in the fourth quarter. In contrast, the real wage, the nominal wage deflated by the CPI, fell 3.5% year-on-year in the third quarter and by 2.4% in the fourth quarter, influenced by the steep upward trend of prices in the latter half of the year.

<Table I-5> **Wage increases[1)]**

(%)

	2010	2011 Year	2011 Q1	2011 Q2	2011 Q3	2011 Q4
Nominal wages	6.8	1.0	0.2	1.4	0.6	1.5
Real wages	3.8	-2.9	-3.5	-2.5	-3.5	-2.4

Note: 1) Compared with the same periods of the previous years.
Source: Ministry of Employment and Labor.

(3) External transactions

(a) **Current Account**

The current account sustained its underlying surplus during the latter half of 2011, centering on the goods account. By quarter, the current account registered a surplus of 6.9 billion dollars in the third quarter of 2011 and of 11.5 billion dollars in the fourth quarter. In January this year, however, it marked a deficit of 0.8 billion dollars owing to the effects of the Lunar

<Table I-6> **Balance of payments**

(billion dollars)

	2010	2011[P] Year	2011[P] Q1	2011[P] Q2	2011[P] Q3	2011[P] Q4	2012[P] Jan.
Current account	29.4	26.5	2.6	5.5	6.9	11.5	-0.8
Goods	40.1	31.0	5.8	7.7	7.2	10.2	-1.4
Exports	461.4	552.6	127.7	142.7	141.4	140.8	41.5
Imports	421.4	521.6	121.8	135.1	134.2	130.5	43.0
Services	-8.6	-4.4	-2.5	-0.8	-1.2	0.2	-0.1
Credit	87.3	95.0	21.4	23.2	23.9	26.5	8.6
Debit	95.9	99.4	23.9	23.9	25.1	26.4	8.7
Income	1.0	2.5	0.4	-0.8	1.3	1.6	1.2
Current transfers	-3.1	-2.5	-1.1	-0.5	-0.4	-0.5	-0.4
Capital and Financial account	-27.5	-32.0	-2.8	-6.8	-8.3	-14.1	1.2
Capital account	-0.2	0.2	-0.2	-0.1	0.2	0.2	0.0
Financial account	-27.3	-32.1	-2.6	-6.7	-8.6	-14.3	1.2
Direct investment	-22.2	-15.7	-4.7	-4.1	-2.8	-4.1	-2.0
Portfolio investment	42.5	10.3	-1.4	2.0	8.1	1.5	7.7
Financial derivatives	0.8	-1.7	0.7	-0.5	-1.5	-0.4	0.4
Other investment	-21.4	-11.1	6.3	-1.4	-18.7	2.8	-2.3
Changes in reserve assets[1)]	-27.0	-13.9	-3.5	-2.6	6.3	-14.1	-2.7
Errors and omissions	-1.9	5.5	0.1	1.3	1.4	2.6	-0.4

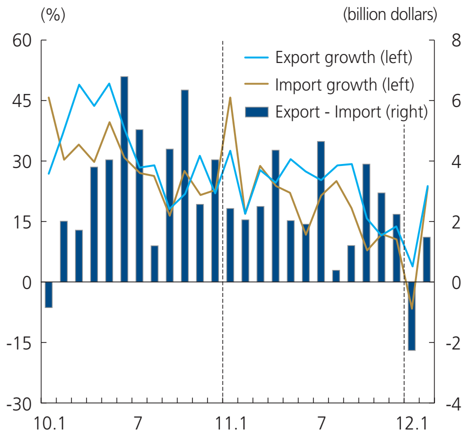
Note: 1) (-) indicates increase, whereas (+) indicates decrease.
Sources: The Bank of Korea, Korea Customs Service.

New Year holiday Falling earlier this year.

In terms of component accounts, the goods account registered a surplus of 7.2 billion dollars in the third quarter thanks to the robust upward trend of exports until then. From the fourth quarter, the expansionary pace of goods exports flattened out greatly but the upward trend of goods imports declined even more sharply, so that the surplus widened to 10.2 billion dollars. The services account registered a third quarter deficit of 1.2 billion dollars but went on to exhibit a fourth quarter surplus of 0.2 billion dollars helped by the buoyancy of the construction services account and the reduced scale of the travel account deficit. Meanwhile, the income account displayed a surplus of 1.3 billion dollars in the third quarter and one of 1.6 billion dollars in the fourth quarter. The current transfers account registered a deficit of 0.4 billion dollars in the third quarter and of 0.5 billion dollars in the fourth quarter.

Exports (customs-clearance basis) grew solidly 21.1% year-on-year in the third quarter, boosted by the continued buoyancy of exports of cars, and petroleum and petrochemical products, but increased by just 11.2% in the fourth quarter because of the accelerated downward trend of IT product exports such as mobile phones and the flattening-out exports of petroleum and petrochemical products, and of ships. The amount of exports reached 141.4 billion dollars in the third quarter and 140.8 billion dollars in the fourth quarter. Imports (customs-clearance basis) increased 27.6% year-on-year in the third quarter to stand at 134.2 billion dollars, led by raw materials, notably crude oil, gas, and petroleum products, and by consumer goods items. From the fourth quarter, though, the growth rate of imports slowed greatly to stand at 13.8% thanks to the slowdown in the upward trend of raw materials and consumer goods, and the decrease in capital goods owing to depressed facilities investment.

<Figure I-27> **Export & import growth[1] and export-import gap**



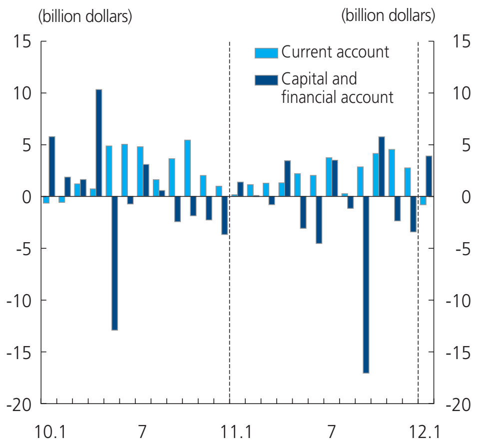
Note: 1) Compared with the same periods of the previous years; customs-clearance basis.
Source: Korea Customs Service.

(b) **Capital and Financial Account**

The capital and financial account registered a net outflow of 8.3 billion dollars in the third quarter and of 14.1 billion dollars in the fourth quarter.

Broken down by component account, the direct investment account exhibited a net outflow of 2.8 billion dollars in the third quarter and of 4.1 billion dollars in the fourth quarter due to the increase in foreign direct investment. The portfolio investment account registered a net inflow of 8.1 billion dollars in the third quarter, but it narrowed sharply to 1.6 billion dollars in the fourth quarter because of an outflow of foreigners' equity investment funds. As for financial derivatives investment, its net outflow narrowed from 1.5 billion dollars in the third quarter to 0.4 billion in the fourth quarter. The other investment account witnessed a net outflow of 18.7 billion dollars in the third quarter owing to large-scale redemptions of banks' short-term borrowings, following the newly imposed Macro-prudential Stability Levy. It shifted, however, to a net inflow of 2.8 billion dollars in the fourth quarter due to the narrowed scale of short-term borrowings redemption and increased inflows of cash and deposits.

<Figure I-28> **Current account and capital and financial account**[1)]



Note: 1) Excludes reserve assets.
Source: The Bank of Korea.

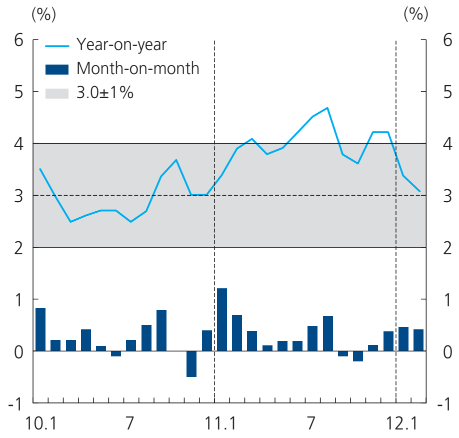
B. Prices

(1) Consumer Prices

After registering 4.7% in August 2011, consumer price inflation (year-on-year) gradually fell, owing to the slackening of domestic economic activity and the stability of agricultural and livestock product prices but it nevertheless exhibited a high level of around 4%.

By period, consumer price inflation, after rising to 4.7% in August, slowed to 3.6% in October thanks to the stability of the prices of agricultural and livestock products, and of public utility charges. In November and December, the scale of the increase in consumer prices widened once more amid price rises for certain agricultural products such as ground red pepper and processed foods. From the beginning of this year, however, the scale of the increase fell back greatly because of a base effect. The year-on-year rate of increase stood at 4.3% in the third quarter and 4.0% in the fourth quarter of 2011, but for the first two months of this year it registered 3.2%.

<Figure I-29> **Consumer prices**



Source: Statistics Korea.

In terms of commodity group, prices of agricultural, livestock, and marine products increased at a 9.5% rate year-on-year in the third quarter owing to a sharp rise in the prices of vegetables following localized heavy rains in the summer season. However, these prices stabilized thereafter to exhibit a rise of 2.8% in the fourth quarter and of 1.9% in January and February this year. The rate of increase in the prices of industrial products stood at 5.5% in the third quarter

<Table I-7> **Consumer prices[1)]**

(%)

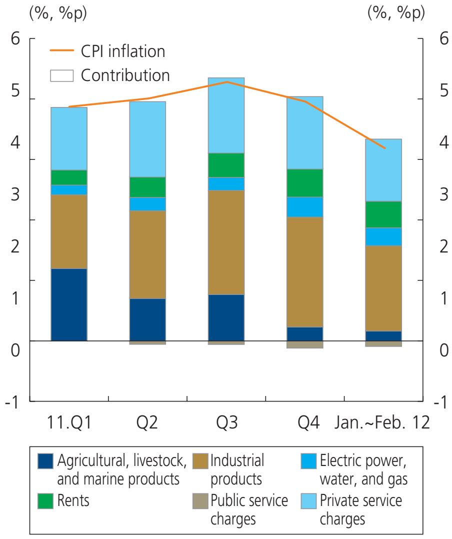
	2010	2011					2012
		Year	Q1	Q2	Q3	Q4	Jan.~Feb.
Consumer price index	3.0 (3.0)	4.0 (4.2)	3.8 (2.3)	4.0 (0.5)	4.3 (1.1)	4.0 (0.3)	3.2 (0.9)
Agricultural, livestock, and marine products	10.0	9.2	16.0	9.1	9.5	2.8	1.9
(Agricultural products)	13.5	8.8	20.4	7.6	8.9	-0.2	5.1
(Livestock products)	1.1	10.3	11.0	12.8	10.8	6.6	-4.2
Industrial products	3.2	4.9	3.8	4.6	5.5	5.8	4.5
(Petroleum products)	9.2	13.6	12.7	12.6	14.7	14.5	7.5
(Other industrial products)[2)]	2.0	3.2	2.0	3.1	3.6	4.1	3.9
Electric power, water, and gas	–	4.8	3.2	4.4	4.6	6.8	5.7
Services	1.9	2.7	2.3	2.8	2.9	2.7	2.6
(Rents)	1.9	4.0	2.7	3.7	4.4	5.0	5.0
(Public Service charges)	1.2	-0.4	0.1	-0.4	-0.5	-1.0	-0.6
(Private Service charges)	2.2	3.7	3.2	3.9	3.9	3.8	3.2
CPI for living necessaries	3.4	4.4	4.4	4.2	4.7	4.1	3.1
CPI excluding agricultural products & oils	1.8	3.2	2.6	3.2	3.4	3.4	2.8
CPI excluding food & energy	1.9	2.6	2.2	2.6	2.7	2.7	2.6

Notes: 1) Compared with the same periods of the previous years; figures in parentheses refer to the rates of increase of the last month of each period compared with the last months of the previous periods.
2) Excludes petroleum products.
Source: Statistics Korea.

and 5.8% in the fourth quarter as the exchange rate of the Korean won against the US dollar rose, added to which international oil prices maintained a high level and the prices of processed foods accelerated their pace of increase. In the first two months of this year, however, their rate of increase declined to 4.5%. Meanwhile, the rate of increase in prices of charges for services, after registering 2.9% in the third quarter, flattened out to stand at 2.7% in the fourth quarter and at 2.6% in the January and February of this year as the scale of the decrease in public service charges widened and personal service charges showed stable trends while the rise in housing rents steepened.

In terms of the contribution to the rate of increase in the CPI by individual commodity group, that of agricultural, livestock, and marine products, after recording a contribution of 0.75 percentage points in the third quarter, stabilized to a contribution of 0.22 percentage points in the fourth quarter and to 0.16 percentage points in January and February of this year. The contribution of industrial products led the overall upward trend in prices, registering 1.74 percentage points in the third quarter and 1.83 percentage points in the fourth quarter, but it fell to 1.43 percentage points in the first two months of this year. Charges for services exhibited a contribution of around 1.60 percentage points throughout the latter half of 2011, but it fell to 1.41 percentage points in January and February of this year.

<Figure I-30> Contributions to CPI inflation[1]



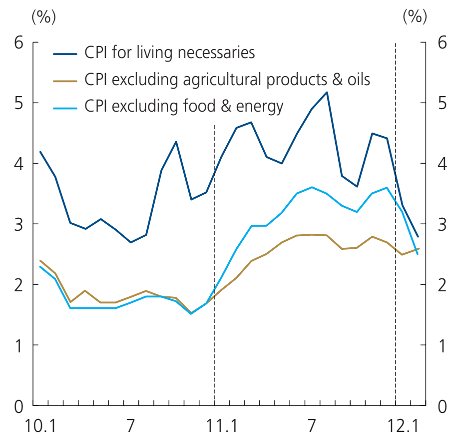
Note: 1) Compared with the same periods of the previous years.
Source: Statistics Korea.

Consumer price inflation for living necessaries, which focuses on essential items purchased frequently by consumers, showed an overall downward trend, but it was greatly influenced by fluctuations of prices in agricultural and livestock products. By period, after it had risen 4.7% year-on-year during the third quarter, it decelerated to 4.1% in the fourth quarter and to 3.1% in January and February of this year.

(2) Core Inflation

The rate of core inflation maintained a high level during the latter half of 2011 as supply shocks, due for example to the sharp run-ups in international oil prices, was passed through with some time lag to drive up the prices of other commodities, but it showed a downward trend because of the base effect from the previous year. By period, the index that strips out agricultural products and oils rose at a rate of 3.4% in the third and fourth quarters, but decelerated to 2.8% for January and February of this year. The index that strips out food and energy also rose to 2.7% in the third and the fourth quarters, but subsequently registered 2.6% in the first two months of this year.

<Figure I-31> **CPI for living necessaries and core inflation**[1)]



Note: 1) Compared with the same periods of the previous years.
Source: Statistics Korea.

(3) Producer Prices

The year-on-year rate of increase in the producer price index, after registering 6.6% in August 2011, declined sharply to stand at around the 3% level in January this year. By quarter, the rate in the third quarter stood at 6.2%, that in the fourth quarter at 5.0%, and that in January and February of this year at 3.5%.

In terms of product group, the year-on-year rate of increase in prices of agricultural, forestry and fishing products followed a steeply downward track, dropping from 5.1% in the third quarter to -2.1% in the fourth quarter and then to -6.2% in the January and February of this year. The rate of increase in prices of industrial products declined from 8.1% in the third quarter to 6.7% in the fourth quarter and then to 4.5% in January and February this year led by petroleum and petrochemical products. The rate of increase in charges for services continued its stable trend: after registering 1.9% in the third quarter, it stood at 1.3% both in the fourth quarter and in the first two months of this year.

(4) Export and Import Prices

Export prices (Korean-won basis) increased from the latter half of 2011 as the prices of textiles and clothing, and leather

<Table I-8> **Producer prices, and export and import prices (Korean-won basis)[1]**

(%)

	2010	2011					2012
		Year	Q1	Q2	Q3	Q4	Jan.~Feb.
All items	3.8 (5.3)	6.1 (4.3)	6.7 (3.6)	6.4 (-0.1)	6.2 (0.8)	5.0 (0.0)	3.5 (1.5)
Goods	4.6	7.5	8.3	7.9	7.7	6.3	4.1
(Agricultural, forest, and marine products)	9.0	7.4	21.0	6.7	5.1	-2.1	-6.2
(Industrial products)	4.2	7.7	7.9	8.2	8.1	6.7	4.5
(Electric power, water, and gas)	4.0	5.8	3.3	4.6	5.7	9.5	10.3
Services	1.7	1.8	1.9	2.2	1.9	1.3	1.3
Export prices[2]	-2.6 [7.5]	4.4 [8.3]	6.6 [8.7]	3.4 [9.7]	2.1 [10.5]	5.6 [4.4]	3.3 [1.9]
Import prices[2]	5.3 [15.5]	13.4 [17.6]	16.9 [18.9]	14.2 [21.2]	11.3 [20.6]	11.5 [10.1]	6.5 [4.9]
(Raw materials)	16.7	27.6	30.9	29.9	25.5	24.7	14.6
(Intermediate goods)	1.8	7.0	11.8	7.1	5.1	4.2	1.3
(Capital goods)	-8.8	-0.9	0.1	-1.8	-4.7	2.8	2.0
(Consumer goods)	-3.2	1.5	2.9	0.8	-0.8	3.0	3.1
Exchange rate[3]	10.4	4.3	2.1	7.3	9.5	-1.0	-1.3

Notes: 1) Compared with the same periods of the previous years; figures in parentheses refer to the rates of increase of the last month of each period compared with the last months of the previous periods.
2) Figures in square brackets are contract-currency basis.
3) Rates of appreciation(+) or depreciation(-) of Korean won compared with the US dollar (period-average).
Source: The Bank of Korea.

products and transport equipment rose by a large margin, but from the beginning of 2012, the upward trend decelerated owing in part to the economic slowdown in the euro area. By quarter, they accelerated from 2.1% year-on-year in the third quarter to 5.6% quarter in the fourth quarter, but then slowed to 3.3% in January and February of this year.

Import prices (Korean-won basis) rose at a slower pace as the increase in commodity prices declined from its peak in the first half of 2011. By quarter, their rate of increase rose 11.3% in the third quarter, 11.5% in the fourth quarter, and 6.5% in the first two months of this year.

On a contract-currency basis, which excludes the effects of exchange rate fluctuations, the scale of increase in both export and import prices narrowed consistently.

(5) Real Estate Prices

As for house prices, in the second half of the 2011 they showed a mild downward trend in Seoul and its surrounding area, while sustaining their upward trend in the rest of the country, albeit at a somewhat lower rate. By period, the upward pace slowed somewhat from the third quarter as

<Table I-9> **House prices, leasehold deposits, and land prices[1]**

(%)

	2010	2011					2012
		Year	Q1	Q2	Q3	Q4	Jan.~Feb.
House prices	1.9	6.9	2.3	2.0	1.5	1.0	0.3
Seoul and its surrounding area	-1.7	0.5	0.7	0.1	-0.1	-0.2	-0.2
(Seoul)	-1.2	0.3	0.6	0.0	-0.1	-0.2	-0.2
Rest of country	6.4	15.1	4.2	4.6	3.3	2.2	0.9
Leasehold deposits	7.1	12.3	4.3	2.7	3.3	1.5	0.6
Seoul and its surrounding area	6.3	11.0	4.4	1.8	3.5	0.8	0.2
(Seoul)	6.4	10.8	4.1	1.5	3.8	1.0	0.3
Rest of country	9.2	14.5	4.4	4.1	3.1	2.1	1.0
Land prices	1.0	1.2	0.3	0.3	0.3	0.3	0.1[2]

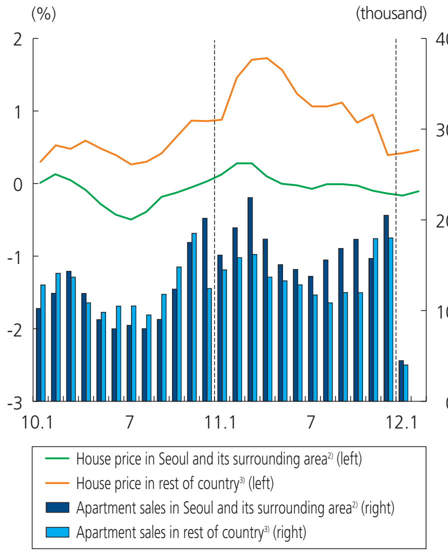
Notes: 1) Compared with the last months of the preceding periods.
2) January 2012 basis.
Sources: Ministry of Land, Transport and Maritime Affairs, Kookmin Bank.

those in Seoul and its surrounding area shifted to a downward track whereas those in regions other than Seoul and its surrounding area held to their strongly upward trend owing to imbalances between supply and demand, along with provincial development plans. From the beginning of this year, while the mild downward trend continued in Seoul and its surrounding area, upward momentum elsewhere was constrained by the burden of sustaining a sharp rise over a short period.

Meanwhile the volume of house sales, which had increased from July onwards led by those in Seoul and its surrounding area, rose by a large margin in the majority of areas in December, ahead of the cut-off deadline for exemption from acquisition tax.

The scale of the increase in leasehold deposits widened in the third quarter centering on those in Seoul and its surrounding area, due to a shortage of available apartments and to seasonal

<Figure I-32> **House prices and apartment sales[1]**



Notes: 1) Based on number of completed sales reported.
2) Seoul, Gyeonggi and Incheon.
3) Five metropolitan cities (Busan, Daegu, Gwangju, Daejeon, and Ulsan).
Sources: Ministry of Land, Transport and Maritime Affairs, Kookmin Bank.

demand for house moving with the coming of autumn. From the beginning of the fourth quarter, their pace of increase, however, slackened greatly, influenced by the burdens stemming from their steep upward trend until then and the rise was also slight from the beginning of this year.

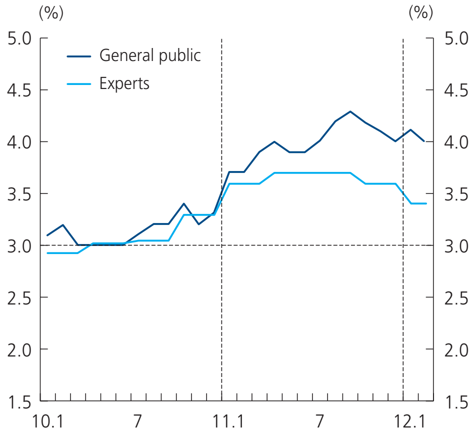
Land prices rose, led by increases in those of certain areas touted for development, including areas where the Winter Olympics are to be held and sites for low-cost housing. They exhibited an upward trend, increasing 0.3% compared with the last month of the preceding quarter both in the third and fourth quarter and registering a similar rate of increase in January this year.

(6) Inflation Expectations

As estimated through the Bank of Korea's regular survey of economic agents, inflation expectations have shown only a slow retreat from their high level of between around 3.5% and slightly over 4%.

The general public's inflation expectations, as based upon the survey of expectations of price increases over the next one year, registered 4.2% in the third quarter of 2011, 4.1% in the fourth quarter, and 4.1% in January and February this year. Inflation expectations as researched by a panel of experts registered 3.7% in the third quarter and 3.6% in the fourth quarter, before inching down to 3.4% in the first quarter of 2012.

<Figure I-33> **Inflation expectations[1)]**



Note: 1) Results are taken from the monthly survey of general public and the quarterly survey of experts as to the rate of inflation for the coming twelve months.
Source: The Bank of Korea.

BOX

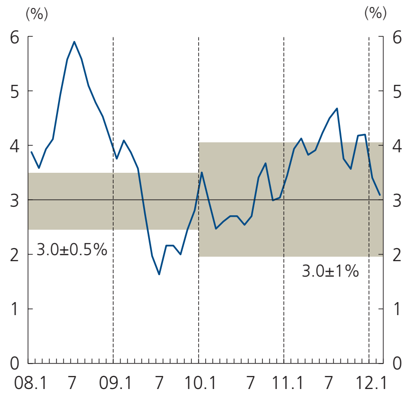
I-1

A Review of the Performance of Inflation Targeting during 2011

Inflation Targeting and Inflation during 2011

The Bank of Korea reviews and explains the performance of medium-term inflation targeting annually. The current inflation target is 3.0±1% in terms of the 12-month rate of change in consumer price index and its period of application is three years from 2010 to 2012. A tolerance range of plus or minus one percentage point from the mid-point of the medium-term inflation target has been established in order that decisions on the direction of policy can be made from a medium and long-term viewpoint, by considering the underlying trend of prices since it is difficult to respond to rapid changes in prices such as those resulting from a temporary supply shock.

The inflation target and consumer price inflation[1]



Note: 1) Compared with the same periods of the previous years.
Source: Statistics Korea.

Looking at Inflation in the course of 2011, annual consumer price inflation exhibited a rate of 4.0%, reaching the upper bound of the inflation target and it rose above the upper bound of the target on six occasions in monthly terms.

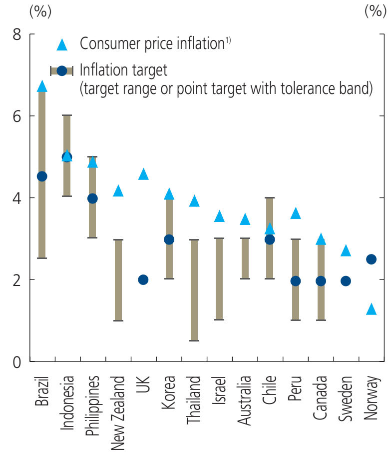
The number of deviations from the tolerance range of the inflation target (± 1%p)

	2007~2009[1]				2010	2011
	Subtotal	2007	2008	2009		
Total	12 [29]	1 [7]	9 [12]	2 [10]	0	6
Upside deviation	10 [17]	0 [1]	9 [12]	1 [4]	0	6
Downside deviation	2 [12]	1 [6]	0 [0]	1 [6]	0	0

Note: 1) Figures in square brackets are the number of deviations on the basis of deviation from the tolerance range (±0.5%p) of the inflation target.
Sources: The Bank of Korea, Statistics Korea.

During 2011, the rate of increase in the CPI rose from the 3.0% of the preceding year to 4.0%. This was attributable in part to the increasing demand-side pressures resulting from the business upswing, but rather more fundamentally it was largely driven by supply-side factors including the sharp run-ups in international oil prices and widespread outbreaks of foot and mouth disease. International oil prices rose steeply, affected by abnormally cold weather in the northern hemisphere and the political unease in the Middle East and North Africa (MENA), and prices of livestock products and the cost of eating-out accelerated their upward trend because of widespread outbreaks of foot and mouth disease. Weather conditions such as much heavier summer rainfall than normal in recent years also exercised a negative influence on agricultural harvests. Breaking down the one percentage point rise in the rate of increase in the CPI by factor, it is estimated that supply-side factors contributed 0.9 percentage points and inflation persistence and demand-side factors together 0.1 percentage points.

Price conditions in countries opting for inflation targeting



Note: 1) For 2011, core inflation for Thailand.
Sources: Individual countries' central banks, Bloomberg.

Ratios of raw materials imports to GDP[1] by nation

(%)

	Korea	India	UK	China	Euro area	US
Ratio	24.3	12.0	11.7	11.3	6.9	6.2

Note: 1) On the basis of the first nine months of 2011 for Korea and on that of 2010 for other countries.
Sources: The Bank of Korea, KITA, UN Comtrade, CEIC, Datastream.

Other countries that have opted for an inflation targeting regime, similarly, last year experienced rates of price increases higher than the target or at the upper bound of the target range, being affected by global supply shocks such as the sharp run-ups in international oil prices. In particular, the Korean economy experienced greater volatility in economic activity and prices caused by external shocks than other countries because of its high degree of external dependency for raw materials.

Furthermore, because of the high degree of openness of the Korean financial and capital markets, consumer prices tended to accelerate their upward trend in a situation of international financial market unrest, in accordance with the rise of the Korean won/US dollar exchange rate despite the drop of international oil prices.

International oil prices and exchange rate[1]

(%)

	2011			
	Q1	Q2	Q3	Q4
International oil price (Dubai crude basis)	19.1	9.9	-3.0	-0.7
Korean won/ US dollar exchange rate	-1.1	-3.3	0.2	5.4

Note: 1) Compared with the previous periods.
Sources: Bloomberg, Korea Money Brokerage Corp., Seoul Money Brokerage Services Ltd.

Conduct of Monetary Policy

Under these price conditions, the Bank of Korea conducted monetary policy with an emphasis on stabilizing consumer price inflation at the midpoint of the inflation target over a medium-term horizon amid continuing sound growth of the economy.

During the first half of 2011, the Bank consistently reduced the degree of monetary accommodation, raising the Base Rate by 0.25 percentage points each time in January, March, and June 2011, given the increase in upward price pressures as the upswing in economic activity continued. It raised the interest rate on Aggregate Credit Ceiling Loans on a restricted scale in March, from 1.25% to 1.50% in view of financial conditions for SMEs. During the latter half-year, taking into consideration the high degree of uncertainty as to the future economic outlook owing to the sovereign debt problems in Europe, the Bank kept the Base Rate unchanged, but continued its efforts to withdraw the liquidity it had provided during the global financial crisis. Total liquidity of 5 trillion won was withdrawn during 2011 through the lowering of the Aggregate Credit Ceiling and the reduction of its support for the Bank Recapitalization Fund and the Bond Market Stabilization Fund.

BOX

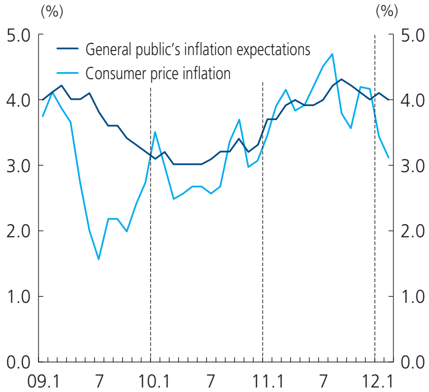
I-2

Reasons for the Divergence between CPI Inflation and Perceived Inflation

From the beginning of this year, the upward trend of consumer prices eased but the divergence between CPI inflation and consumers' perceived inflation has not narrowed to any great degree.

As the prices of livestock products and the cost of eating-out stabilized, the scale of the increase in consumer prices decreased greatly from a level of 4% of last year to a little above 3% in January and February of this year.

CPI inflation and the general public's inflation expectations[1)2)]



Notes: 1) Compared to the same periods of the previous years.
2) Results of the Bank of Korea's monthly survey of some 2,200 households nationwide as to the rate of inflation expectations for the coming twelve months.
Sources: The Bank of Korea, Statistics Korea.

On the other hand the general public's inflation expectations still exhibited as before a level of 4% from the beginning of this year, reflecting the high perceived inflation of consumers.

This high level of perceived inflation was caused mainly by the continued steep upward trend of the prices of petroleum products and foodstuffs and the cost of eating-out, which are closely linked to households' everyday consumption. Last year domestic petroleum product prices increased by a wider margin as international oil prices rose, influenced by the political

CPI inflation rates[1)] of major commodity groups

(%)

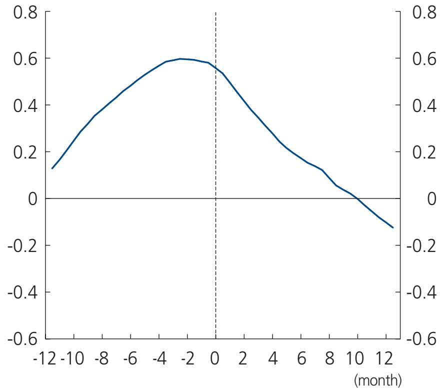
	Usual[2)]	2011				
		Year	Q1	Q2	Q3	Q4
Agricultural, livestock, and marine products	3.8	9.2	16.0	9.1	9.5	2.8
(Food grains)	-0.9	12.4	7.0	13.0	13.6	15.9
(Fruit)	1.6	14.3	26.8	16.7	12.1	4.1
(Livestock products)	3.7	10.3	11.0	12.8	10.8	6.6
Processed foods	4.9	5.7	2.7	4.8	7.1	8.1
Petroleum products	5.4	13.6	12.7	12.6	14.7	14.5
Eating-out charges	2.9	4.3	3.4	4.6	4.8	4.4
Average[3)]	4.0 (3.0)	7.4 (4.0)	7.8 (3.8)	7.1 (4.0)	8.1 (4.3)	6.4 (4.0)

Notes: 1) Compared to the same periods of the previous years.
2) Average rate of increase over the preceding five years (2006-2010).
3) Figures in parentheses are the CPI inflation rates as a whole.
Source: Statistics Korea.

turmoil in the Middle East and North Africa (MENA). The prices of agricultural, livestock, and marine products also rose steeply because of the abnormal weather conditions and outbreaks of foot and mouth disease. As these supply shocks fed through, prices of processed foods and the cost of eating-out also increased by a much wider margin than in the last few years.

The general public's inflation expectations are, statistically speaking, closely correlated with the past CPI inflation rate. The reason that the general public's inflation expectations are continuing to run at a high level again this year is considered to because they are affected by the high rate of price increases last year after some time lag.

Time lagged correlation[1] between the inflation expectations rate (π_t^e) and the CPI inflation rate (π_{t+i})



Note: 1) The sample period is from January 2000 until December 2011.

C. Financial Markets

(1) Interest Rates and Share Prices

(a) Short-Term Market Interest Rates

Short-term market interest rates halted their upward trend and exhibited no marked changes as the Bank of Korea kept the Base Rate unchanged from the second half of 2011. In the process, yields on Monetary Stabilization Bonds (91-day) moved one basis point below the Base Rate on September 14, 2011, influenced by a decline in long-term market interest rates, but they then recovered to their previous level. Yields on CDs (91-day) intensified their stickiness as the issue of CDs and their secondary market volume dropped sharply in response to the effect of regulations on the loan-deposit ratio.

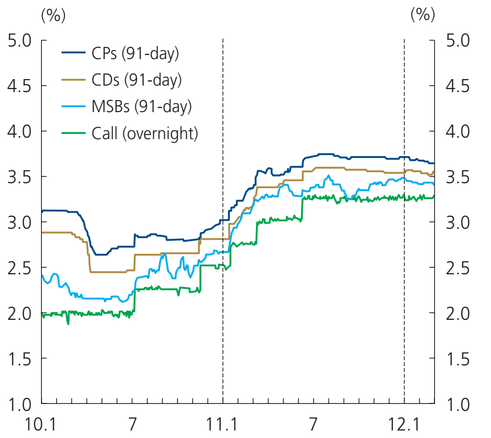
<Table I-10> **Market interest rates[1)]**

(%)

	2010	2011				2012	
		Mar.	Jun.	Sep.	Dec.	Jan.	Feb.
Call (overnight)	2.51	2.99	3.28	3.28	3.29	3.27	3.26
CDs (91-day)	2.80	3.39	3.57	3.58	3.55	3.54	3.54
CPs (91-day)[2)]	3.03	3.59	3.73	3.71	3.71	3.68	3.65
MSBs (91-day)	2.66	3.30	3.39	3.36	3.48	3.41	3.42
Treasury bonds (3-year)	3.38	3.73	3.76	3.55	3.34	3.38	3.45
Corporate bonds (3-year)[3)]	4.19	4.50	4.38	4.45	4.10	4.05	4.08

Notes: 1) Period-end basis.
2) A1 credit rating basis.
3) AA- credit rating basis; based on the averages of yields estimated by three private credit rating corporations.
Sources: Koscom Corp., KIS Pricing Inc., Korea Asset Pricing Corp., NICE Pricing Services Inc.

<Figure I-34> **Short-term market interest rates**

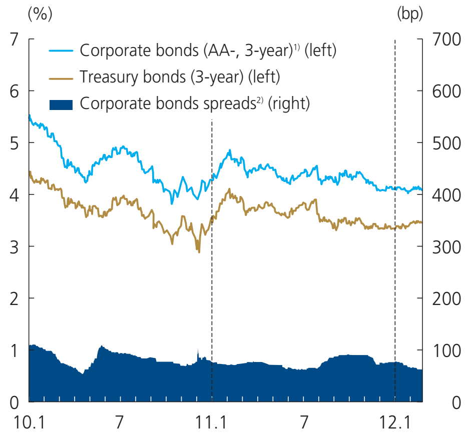


Source: Koscom Corp.

(b) Long-Term Market Interest Rates

Secondary market yields on Treasury bonds (3-year) fell back sharply from early August 2011 amid worries about major countries' economic slowdown, the sovereign debt problems in Europe, and the downward adjustment of the US sovereign credit rating so that they reached the lowest rate for the year of 3.31% on September 14. Subsequently they fluctuated within a narrow range of 3.3~3.6% in response to the evolution of the sovereign debt problems in Europe. Foreigners' bond investment funds, notwithstanding the international financial market unrest including the sovereign debt problems in Europe, recorded a net inflow for the year of 8.8 trillion won, which originated predominantly from Asian central banks, and this acted as a factor putting downward pressure on long-term market

<Figure I-35> Long-term market interest rates



Notes: 1) Based on the averages of yields estimated by three private credit rating corporations.
2) Corporate bond (AA-, 3-year) yield minus Treasury bond (3-year) yield.
Sources: Koscom Corp., KIS Pricing Inc., Korea Asset Pricing Corp., NICE Pricing Services Inc.

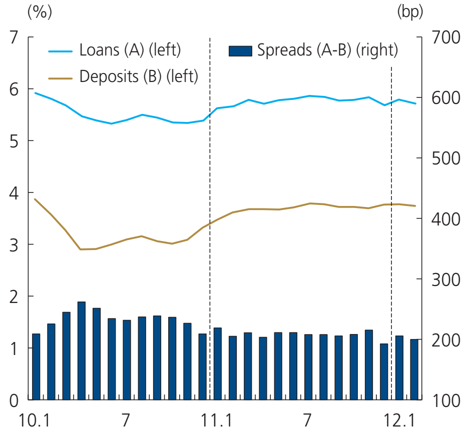
rates. From the beginning of 2012, yields picked up on the easing of the euro area risks and the waning of anticipations of a Bank of Korea Base Rate hike, so that as of end-February they had risen to 3.45%.

Secondary market yields on corporate bonds (AA -, 3-year) followed a very similar pattern of movements to those on Treasury bonds, and the spread between the two, after rising to 91 basis points on September 22, 2011, continued a narrowing trend that brought it to 63 basis points as of end-February 2012.

(c) Bank Loan and Deposit Rates

Bank loan and deposit rates (newly-handled amount basis) rose in July 2011 under the lingering influence of the Base Rate hike in June, but from August onwards they followed a comparatively stable pattern of movements. As of the end of February 2012, the average interest rate on bank's loans stood at 5.71%, which was lower than 5.80% of June of the previous year and that on their savings deposits stood at 3.72%, which was slightly higher than the 3.70% of last June. The spread between loan and deposit rates maintained a mildly narrowing trend from May 2010, registering 1.99 percentage points in February 2012.

<Figure I-36> Interest rates[1] on bank loans and deposits, and loan-deposit spread

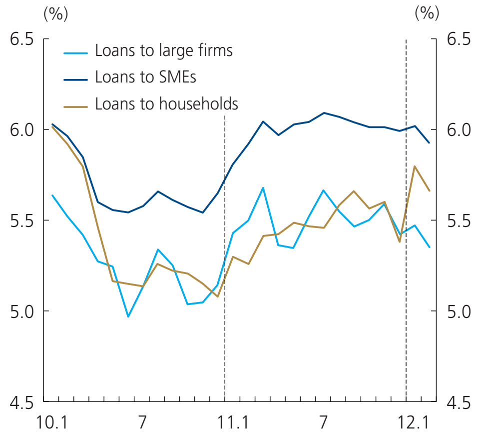


Note: 1) Based on newly-handled loans and deposits; the figures for February 2012 are preliminary.
Source: The Bank of Korea.

Viewed by type of borrower in the latter half of 2011, the average interest rates on loans to corporations initially rose from 5.89% in June to 5.98% in July in response to the rise in market interest rates but thereafter it fell back under the influence of banks' efforts to expand their lending to register 5.74% in February 2012. In the case of interest rates on loans to large firms, there were fairly large-scale fluctuations depending upon the credit status of the borrowing firm and loan maturity.

Interest rates on loans to households, meanwhile, continued an upward trend from the beginning of the latter half of the year owing to banks' conservative attitude toward lending in line with government measures to curb household debt and the extension of fixed-rate loans at relatively high interest rates. They dropped for a while in December as the volume of collective loans at low interest rates for the purchase of new apartments increased ahead of the ending of acquisition tax exemption, but picked up again from the beginning of the new year once this factor disappeared. In February 2012 interest rates on loans to households stood at 5.66%, which was 0.19 percentage points higher than the 5.47% in June 2011.

<Figure I-37> Interest rates1) on bank loans by type of borrower

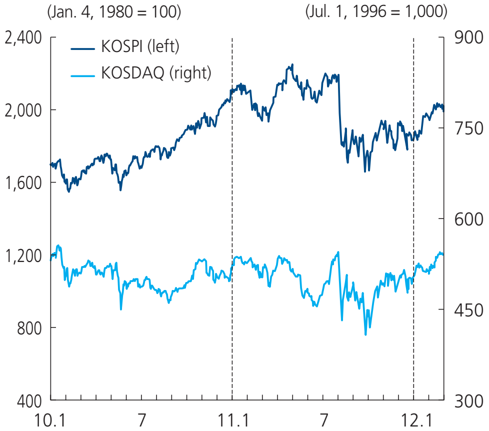


Note: 1) Based on newly-handled loans and deposits; the figures for February 2012 are preliminary.
Source: The Bank of Korea.

(d) Share Prices

The KOSPI shifted to a steeply downward trend from early August upon the downward adjustment of the US sovereign credit rating and the emergence of the sovereign debt problems in Europe. It reached its lowest point for the year of 1,652.7 on September 26. Subsequently it fluctuated widely in line with the evolution of the sovereign debt problems in Europe but then rose sharply

<Figure I-38> KOSPI and KOSDAQ index

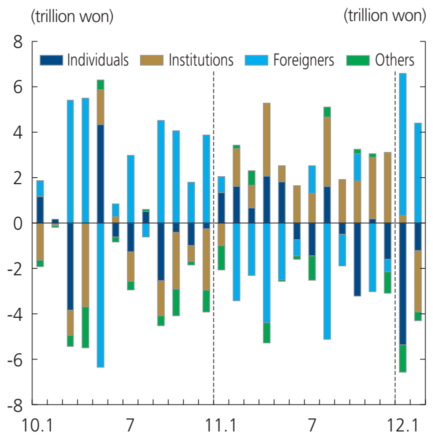


Source: Koscom Corp.

from mid-January this year under the combined influences of the ECB's provision of long-term liquidity, improved US economic indicators, and large-scale net inflows of foreigners' equity investment funds. As of the end of February 2012, KOSPI registered 2,030.3, which was 3.4% down compared with the end of June 2011.

Looking at the trend of share transactions by type of investor, foreigners were large-scale net sellers of Korean shares from August onwards following the emergence of the sovereign debt problems in Europe, but from early 2012 they became large-scale net buyers, helped by the moderation of euro area risks. Consequently foreign share holdings as a percentage of total Korean stock market capitalization declined to 30.0% as of the end of August 2011, but picked up slightly to 30.9% as of the end of February 2012. By nationality, European-based investors, being particularly sensitive to the sovereign debt problems in Europe, led the net selling of equities. Meanwhile domestic institutional investors maintained their net buying trend during the latter half of 2011, led by pension funds, but from early 2012 changed to a net selling position. Individual investors continued to be net sellers apart from the months of August and November 2011 because of the waning of investor confidence and profit-taking.

<Figure I-39> Net purchases of stocks by type of investor



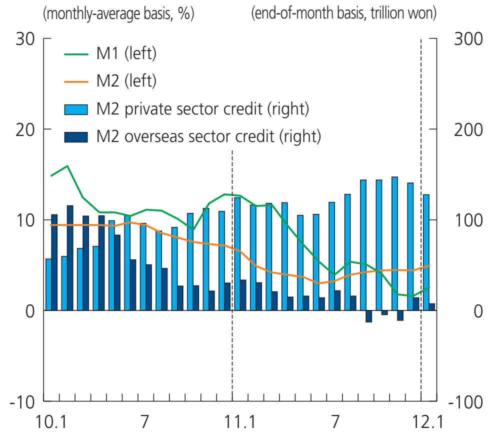
Source: Koscom Corp.

(2) Monetary Aggregates and Financial Institutions' Deposits

(a) Monetary Aggregates

The year-on-year rate of M2 (broad money) growth sustained a rising trend from a low of 3.0% in June as the expansion of private sector credit accelerated despite the net outflows of foreign portfolio investment funds. In February 2012 the growth rate of M2 rose to a level of around 5% in keeping with the greatly increased inflows of foreign portfolio investment funds, led by those for equity investment.

<Figure I-40> M1[1] & M2 growth rates[2] and changes[2] in M2 private and overseas sector credit



Notes: 1) Excluding MMFs.
2) Compared with the same months of the previous years.
Source: The Bank of Korea.

Meanwhile M1(narrow money, excluding MMFs) growth fell back from 5.4% in June 2011 to 2.7% in January 2012 as the upward trend of instant-access deposits was greatly blunted.

(b) Financial Institutions' Deposits

Banks' deposits continued buoyant, led by time & savings deposits, marking increases of 17.8 trillion won in the third quarter of 2011 and of 17.5 trillion won in the fourth quarter. By type of deposit, time deposits increased consistently influenced by the restructuring of mutual savings banks. They nevertheless decreased slightly in the fourth quarter as firms and local governments withdrew funds en masse to meet the year-end demand for funds in December. Demand deposits and instant-access deposits showed small-scale changes and then in December they rose greatly with delayed tax payments due to the New Year holidays, and inflows of fiscal disbursement funds. CDs and other marketable deposits continued their downward trend that was attributable to certain banks' management of loan to deposit ratios. Meanwhile, in the first two months of 2012, banks' deposits declined 1.1 trillion won owing to delayed tax payments and large-scale fund withdrawals by certain institutions.

Asset management companies' deposits increased by 8.1 trillion won in the third quarter of 2011 but declined by 10.6 trillion won in the fourth quarter. By type of deposit, equity funds sustained their net inflow trend but bond funds turned subdued owing to worries about losses arising from the increase in market interest rates. MMFs marked large-scale fluctuations, largely under the influence of in- and outflows of corporate and government funds. New-type funds were initially buoyant, led by derivatives funds but then they turned to a decline upon the large-scale outflow of funds from 'funds of funds' in accordance with the redemption of subscriptions to the Bond Market Stabilization Fund. During the first two months of 2012, asset management

<Table I-11> **Deposit-taking[1] by financial institutions**

(trillion won)

	2010	2011					2012
		Year	Q1	Q2	Q3	Q4	Jan.~Feb.
Commercial & specialized banks[2]	36.9	58.9	4.9	18.8	17.8	17.5	-1.1
Real demand deposits	5.1	7.7	-2.1	4.1	-3.2	8.9	-5.5
Time & savings deposits	112.8	69.4	19.7	13.5	23.4	12.8	9.2
(Time)	95.7	64.1	23.2	18.4	23.6	-1.0	9.7
(Instant access)	20.8	5.6	-1.7	-5.1	-0.9	13.3	-0.4
Marketable deposits[3]	-84.7	-19.4	-10.6	0.6	-3.2	-6.2	-4.8
Asset management companies	-16.7	-16.6	-13.1	-1.0	8.1	-10.6	1.0
MMFs	-4.8	-13.8	-6.4	-6.7	2.5	-3.2	4.8
Equity funds	-25.2	3.2	0.3	0.1	2.4	0.4	-3.9
Bond funds	6.5	-7.7	-7.1	2.6	-1.1	-2.1	-0.3
New-type funds[4]	5.5	4.2	1.8	2.4	3.7	-3.7	0.3
Money trusts[5]	18.0	27.4	11.6	-0.3	12.3	3.8	10.0
Customer's deposit of securities firms	1.9	3.7	1.9	0.0	3.1	-1.3	2.5
Postal savings	6.2	11.1	4.2	2.8	1.9	2.2	-3.5
Mutual savings banks	3.5	-13.8	-3.6	-2.1	-4.4	-3.7	-7.3
Credit cooperatives' deposits[6]	38.2	14.8	1.1	3.7	5.3	4.7	6.8

Notes: 1) Based on changes during the periods.
2) Excluding the deposits of banks, central government, and non-residents.
3) CDs, RPs, cover bills, and bank debentures.
4) Derivatives funds, real estate funds, funds of funds, and special asset funds.
5) Money trusts of banks and securities firms.
6) Mutual credit unions, community credit cooperatives, and credit unions.

Sources: The Bank of Korea, Korea Financial Investment Association, Ministry of Knowledge Economy.

companies' deposits increased 1.0 trillion won upon the renewed inflow into MMFs of corporate funds that had flowed out at year-end.

Mutual savings banks' deposits maintained its declining trend, influenced by the suspension of business by certain mutual savings banks, decreasing by 4.4 trillion won in the third quarter of 2011, by 3.7 trillion won in the fourth quarter, and then going on to fall 7.3 trillion won in the first two months of 2012.

On the other hand, credit cooperatives' deposits picked up on a slightly larger scale from the beginning of the second half of the year than the first half of 2011, but presented a more subdued pattern than in 2010.

(3) Corporate Financing and Household Credits

(a) Banks' Corporate Lending

Banks' loans to large firms maintained a rapidly increasing trend, growing by 9.6 trillion won in the third quarter of 2011 and 6.5 trillion won in the fourth quarter because of the reclassification of certain SMEs as large firms, together with firms' increased demand for working capital in line with the economic slowdown at home and abroad and the run-ups in international commodity prices. In January and February of 2012, corporate lending increased by 10.2 trillion won in response to the re-extension of loans temporarily redeemed at the previous year-end and to certain firms' efforts to secure liquidity.

Loans to SMEs increased by 5.2 trillion won in the third quarter of 2011, but then shifted to a fourth-quarter decline of 3.1 trillion won owing to disposals and write-offs of non-performing loans on a large scale and banks' strengthened risk management. In January and February this year newly-handled loans to SMEs amounted to just 2.8 trillion won, a very sharp reduction from the 8.7 trillion won of the same two-month period a year earlier. However, lending to sole traders, which is classed within SME loans, increased by 4.6 trillion won in the third quarter and by 4.2 trillion won in the fourth quarter as banks stepped up their efforts to expand such lending owing to the high proportion of collateral and the low arrears rates. Consequently the weight of lending to sole traders in total SME loans rose by a large margin in 2011, as it had done in 2010.

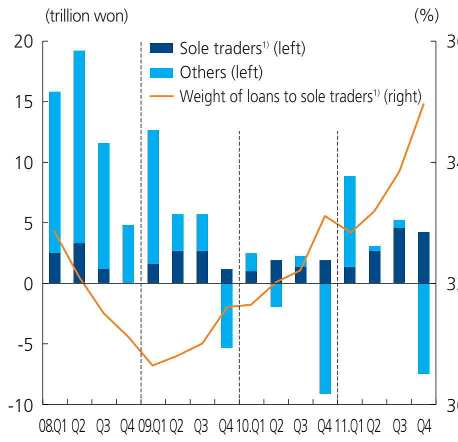
<Table I-12> Financial institutions' corporate loans[1)]

(trillion won)

	2010	2011					2012[2)]
		Year	Q1	Q2	Q3	Q4	Jan.~Feb.
Banks	11.1	43.6	14.8	10.6	14.8	3.4	13.0
Large firms	14.0	29.8	6.0	7.6	9.6	6.5	10.2
SMEs	-2.8	13.8	8.7	3.1	5.2	-3.1	2.8
Non-banks[3)]	-1.5	-10.9	-1.4	-4.6	-2.4	-2.4	-

Notes: 1) Based on changes during the periods.
2) The figures for February 2012 are preliminary.
3) Based on loans by mutual savings banks, credit unions, mutual credit unions, community credit cooperatives, and insurance companies.
Source: The Bank of Korea.

<Figure I-41> Changes in loans to SMEs



Notes: 1) Loans to sole traders are preliminary.
2) Loans to sole traders/total loans to SMEs, an outstanding basis.
Source: The Bank of Korea.

Meanwhile non-bank financial institutions' corporate lending maintained its declining trend, contracting by 2.4 trillion won in the third quarter and again in the fourth quarter under the influence of the suspension of business by some mutual savings banks.

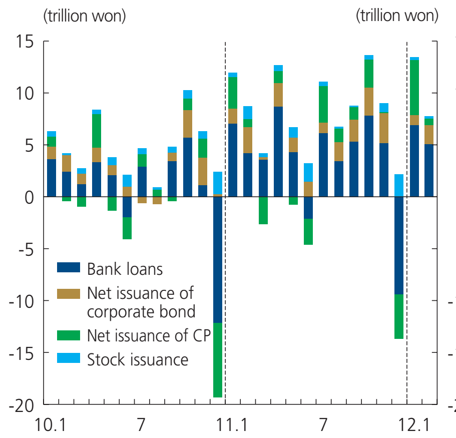
(b) Direct Finance

Firms' fund-raising through the direct financing markets (net increase basis) maintained a brisk pattern, led by the issuance of corporate bonds and CPs. Net issuance of corporate bonds increased by 4.8 trillion won in the third quarter of 2011 and by 5.6 trillion won in the fourth quarter owing to firms' increased demand for working capital as well as to the continuance of low interest rates. It increased by 2.7

trillion won in the first two months of this year due to an increase in the front-loading of issuance for refunding purposes.

The net issuance of CPs decreased by 1.4 trillion won in the fourth quarter owing to firms' debt ratio management at year-end after having increased by 6.3 trillion won in the third quarter. It then increased by 5.3 trillion won in January and February this year upon the reissuing of paper temporarily retired at the previous year-end.

<Figure I-42> Corporate fund-raising



Sources : The Bank of Korea, Financial Supervisory Service, Korea Financial Investment Association.

Fund-raising through share issues marked an increase of just 0.6 trillion won in the third quarter of 2011, influenced by a fall in share prices because of the sovereign debt problems in Europe and so forth, but this increased by 3.3 trillion won in the fourth quarter owing to paid-in capital increases by some corporations to procure funds for working capital and for M&A. In January and February this year, though, the increase stood at just 0.5 trillion won owing to seasonal factors at the beginning of the year.

<Table I-13> Corporate fund-raising by direct financing

(trillion won)

	2010	2011					2012
		Year	Q1	Q2	Q3	Q4	Jan.~Feb.
Corporate bond issuance (net)[1]	11.6	19.5	4.1	5.1	4.8	5.6	2.7
CP issuance (net)[2]	-3.4	3.9	1.2	-2.2	6.3	-1.4	5.3
Stock issuance[3]	8.7	9.2	2.0	3.4	0.6	3.3	0.5
Total	16.9	32.7	7.2	6.3	11.7	7.5	8.6

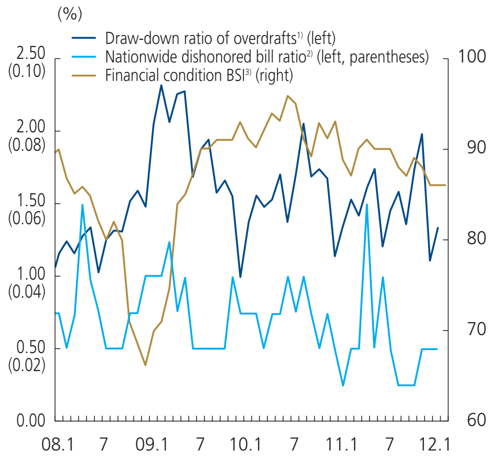
Notes: 1) Based on bonds issued through public subscription by general corporations, and excludes ABSs but includes P-CBOs.
2) Based on CP discounted by securities companies, merchant banking corporations, the merchant banking accounts of banks, and banks' trust accounts.
3) Initial public offerings and paid-in capital increases.
Sources: The Bank of Korea, Financial Supervisory Service, Korea Financial Investment Association.

(c) Corporate Financial Conditions

Corporate financial conditions remained generally favorable, but from the fourth quarter of 2011 presented a somewhat deteriorating picture, centering on both SMEs and marginal corporations facing a weak business conjuncture owing to an increase in external destabilizing factors and the economic slowdowns at home and abroad. From the beginning of this year, though, the deteriorating trend appeared to weaken.

The arrears rates on banks' corporate loans rose rather quickly to reach 2.0% in November 2011 because of the difficult business conditions in some fields and the increased arrears of marginal corporations. In December 2011 and January this year, the rate came down to 1.1% and 1.3%, respectively, in a movement largely attributable to seasonal factors in December including large-scale disposals and write-offs of non-performing loans. By business field, there was a strongly marked rise in the arrears rates of construction and real estate and rental businesses that were in difficulties due to the restructuring of mutual savings banks; and of shipbuilding and marine transport businesses that were experiencing setbacks because of lackluster conditions. Meanwhile the BSI, which surveys corporate financial conditions, slipped from a level of around 90 to the mid-80s from December onwards because of the worsening of cash flow in line with the depressed business situation. Meanwhile the dishonored bill ratio maintained the low level of around 0.02% and the number of corporate insolvencies after increasing from 97 in September to 128 in December, declined to its lowest-ever figure of 94 in February this year.

<Figure I-43> **Major indicators of corporate financial conditions**



Notes: 1) Being in arrears more than 1-day basis.
2) After adjustment for electronic settlements.
3) Based on all industries; proportion (%) of respondents citing 'positive'- proportion (%) citing 'negative'+ 100.
Source: The Bank of Korea.

(d) Household Credits

The scale of the increase in household lending by banks declined somewhat from the third quarter of 2011, under the influence of the 'Comprehensive Measures on Household Debt (June 29, 2011)' announced by the government. Household lending by non-bank financial institutions in contrast maintained an upward trend, led by mutual credit unions and insurance companies.

Banks' household loans, influenced by government measures to rein in household lending and depressed housing sales, increased at a slower pace than in the first half of the year, rising 5.4 trillion won in the

<Table I-14> **Household credits**[1]

(trillion won)

	2010	2011				
		Year	Q1	Q2	Q3	Q4
Commercial & specialized bank loans	22.0	24.4	3.7	9.2	5.4	6.2
(Mortgage loans)	20.3	21.6	5.4	5.4	4.3	6.5
(Credit loans)	1.7	2.8	-1.7	3.7	1.1	-0.3
Non-bank depository corporation loans[2]	37.7	36.2	7.1	8.6	7.7	12.8
(Mutual credit unions)	11.4	12.2	0.9	3.5	2.9	4.9
(Credit unions)	4.0	3.0	1.0	0.8	0.5	0.7
(Community credit cooperatives)	7.2	5.0	0.7	1.6	1.4	1.3
(Insurance companies)	2.0	6.4	0.6	0.5	3.0	2.3
(Mutual savings banks)	0.8	2.0	0.2	0.5	0.5	0.8
(Specialized credit financial companies)	4.8	2.5	0.5	1.4	0.0	0.6
(Others)[2]	7.5	5.1	3.1	0.3	-0.6	2.3
Merchandise credit	7.7	5.4	-0.3	1.1	1.3	3.2
Total	67.3	66.0	10.4	18.9	14.3	22.3

Notes: 1) Based on changes during the periods.
2) Pension funds(including Government Employees Pension Service), public financial institutions(including National Housing Fund, Korean Housing-Finance Corporation), etc.
Source: The Bank of Korea.

third quarter of 2011 and 6.2 trillion won in the fourth quarter. By type of loan extended, mortgage loans marked a consistently upward trend, rising 4.3 trillion won in the third quarter and 6.5 trillion won in the fourth quarter, whereas credit loans increased by just 1.1 trillion won in the third quarter of 2011 and went on to decrease slightly in the fourth quarter. The household loans of non-bank financial institutions expanded on a greater scale, increasing 7.7 trillion won in the third quarter and 12.8 trillion won in the fourth quarter, led by mutual credit unions and insurance companies. This was chiefly attributable to the migration of some part of the demand for loans to the non-bank sector in accordance with the focus of government measures to curb household lending being placed mainly on the banking sector. Meanwhile merchandise credits marked an increase of just 1.3 trillion won in the third quarter owing to the slowdown in domestic business activity, but they increased by 3.2 trillion won in the fourth quarter because of seasonal factors.

<Table I-15> **Implementation date of major policy measures of 'Comprehensive Measures on Household Debt'**

Financial policy measures	Implementation date
<Banking sector>	
■ Applying higher BIS risk weights to high-risk mortgage loans or excessive loans disproportionately concentrated on a certain sector	February 2012
■ Revising standards to evaluate banks' sales performance	July 2011
■ Strengthening banks' ensuring borrowers' debt repayment capability before offering loans	July 2011
■ Strengthening management of loan-to-deposit ratio	July 2011
<Non-banking sector>	
■ Introducing leverage regulations for specialized credit financial companies	December 2012
■ Strengthening loan-loss reserve requirements for credit loans extended by specialized credit financial companies	June 2011
■ Tightening single borrower loan ceilings on credit loans extended by mutual credit unions	February 2012
■ Introducing the ceilings on the sum of credit loans belonging to credit union member	January 2012
■ Strengthening loan-loss reserve requirements for credit loans extended by mutual credit unions	Second quarter of 2012 (Gradually strengthening)

The arrears rate on banks' household loans during the latter half of 2011 inched up slightly compared with the first half of the year but still stood at the low level of 0.8%. The rate of credit card arrears at subsidiaries of banks and stand-alone companies rose slightly in a movement centered on card loans and cash advance services, but still maintained a markedly low level in comparison with that before the financial crisis.

<Table I-16> **Household arrears rates[1]**

(%)

		2010	2011				2012
			Q1	Q2	Q3	Q4	Jan.
Banks	Loans to households[2]	0.7	0.7	0.7	0.8	0.8	0.8
Credit card companies[3]	Subsidiaries of banks	1.9	1.9	1.8	2.0	2.2	2.2
	Stand-alone companies	1.6	1.4	1.5	1.7	1.7	1.7

Notes: 1) The data of years and quarters are average of monthly overdue ratios excluding the last month of each quarter.
2) Being in arrears more than 1-day basis.
3) Being in arrears more than 1-month basis.
Source: Financial Supervisory Service.

BOX

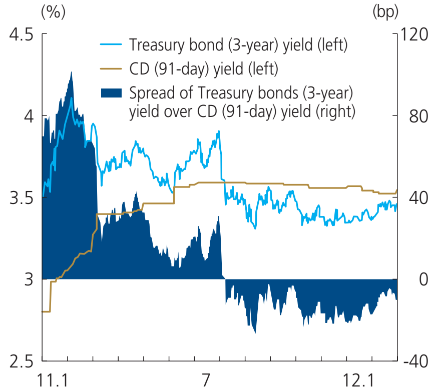
I-3

Background to the Inversion of the Yield Curve between Long-Term and Short-Term Interest Rates

After yields on Treasury bonds (3-year) fell below those of CDs (91-day) on August 9, 2011, the inversion of the yield curve between long-term and short-term interest rates continued until the end of February 2012. This was attributable to the sharp fall in Treasury bond yields in August 2011 and their subsequent persistence at a low level following the downgrade of the US sovereign credit rating and fears of the spread of the sovereign debt problems in Europe whereas CD yields, being geared to the Base Rate, exhibited stickiness in their movements.

The scale of the inversion between long-term and short-term interest rates was shallow in the early stage at 2 basis points (bp), but it subsequently steepened to reach 27 basis points on September 14, 2011 as Treasury bond yields fell further amid expectations of a global economic slowdown in the wake of the sovereign debt problems in Europe and anticipations of a Bank of Korea Base Rate cut. Subsequently the scale of the inversion generally ranged between 10 basis points and 20 basis points until the end of 2011 as Treasury bond yields fluctuated in line with the evolution of the sovereign debt problems in Europe. Moving on into 2012, though, the scale of the inversion narrowed to 9 basis points at the end of this February as international financial market unrest eased and anticipations of the Base Rate cut weakened in tandem with increased concerns about inflation following the run-ups in the international oil prices.

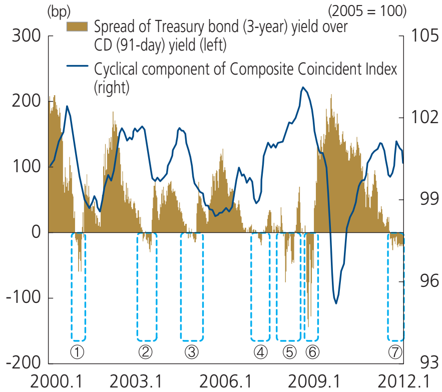
Treasury bond (3-year) and CD (91-day) yields



Source: Koscom Corp.

Inversions of the yield curve have occurred about six times since the year of 2000. In terms of the causes for the inversion of long-term and short-term interest rates, in the majority of episodes, it has come against the backdrop of a sharp drop in long-term interest rates prompted by spreading fears of an economic slowdown or a strengthening preference for safe-haven assets amid heightened financial market unrest. The inversion of

Long-term/short-term interest rate spreads and Composite Coincident Index



Note: [ ] represents previous episodes of yield inversion

Sources: Koscom Corp., Statistics Korea.

long-term and short-term yields that occurred in March 2003, however, is clearly differentiated from other episodes because it happened as short-term interest rates rose by a much greater margin than long-term rates amid the financial market unrest generated by the SK Global scandal.

Previous episodes of long-term/short-term yield inversion have generally reversed themselves after continuing for about four or five months, but this latest yield curve inversion[1] extraordinarily lasted more than seven months. It is analyzed that this was attributable

Episodes of yield curve inversion between Treasury bonds (3-year) and CDs (91-day)

Periods[1]	Scale of change in interest rates prior to inversion[2]	Background to inversion occurring	Scale of change in interest rates prior to the resolution[3]	Background to the resolution of inversion
① 00.12.5~01.3.26 (72 days of inversion during 90 business days)	CD : -8bp, Treasury bonds : -50bp	Spread of pessimistic economic outlook including export sluggishness	CD : +2bp Treasury bonds : +15bp	Acceleration of price rises and anticipations of early economic recovery
② 03.3.18~03.7.9 (70 days of inversion during 78 business days)	CD : +53bp Treasury bonds : +40bp	Sharp rise in MMF redemptions following SK Global scandal	CD : -5bp Treasury bonds : +20bp	Stabilization in the financial market and recognition of global economic recovery and domestic business activity's passing its trough
③ 04.9.21~05.1.11 (51 days of inversion during 78 business days)	CD : +1bp Treasury bonds : -13bp	Anticipations of delay in economic recovery and additional Base Rate reductions	CD : +3bp Treasury bonds : +17bp	Weakening anticipations of the Base Rate cut, anticipations of economic recovery
④ 07.2.7~07.4.19 (45 days of inversion during 50 business days)	CD : +2bp Treasury bonds : -8bp	Fears of economic slowdown prompted by subdued domestic economic indicators	CD : +1bp Treasury bonds : +18bp	Anticipations of domestic economic recovery
⑤ 07.12.26~08.5.27 (95 days of inversion during 105 business days)	CD : +12bp Treasury bonds : -29bp	Fears of domestic economic slowdown following increased sub-prime defaults and sluggishness of MMF deposits	CD : 0bp Treasury bonds : +9bp	Concerns over inflation because of high oil prices and weakened anticipations of the Base Rate cut
⑥ 08.8.6~09.1.7 (91 days of inversion during 111 business days)	CD : +13bp Treasury bonds : -14bp	Fears of economic downturn and waning of concerns over inflation owing to falling oil prices	CD : -78bp Treasury bonds : -61bp	The Base Rate cut
⑦ 11.8.9~12.2.29 (141 days of inversion during 141 business days)	CD : 0bp Treasury bonds : -27bp	Heightened external uncertainties including US sovereign credit downgrade and the sovereign debt problems in Europe		

Notes: 1) Excluding episodes of temporary inversions for less than two days.
2) Scale of change in interest rates for 10 business days prior to inversion day.
3) Scale of change in interest rates for 10 business days prior to resolution day.

1) Moving on into March 2012, the yield curve inversion has persisted up until March 14, 2012.

mainly to the uncertainty as to the economic outlook at home and abroad arising from the delay of resolution in the sovereign debt problems in Europe, which is one of the reasons of the inversion.

Meanwhile, most previous episodes of yield curve inversion appear to have resolved themselves by a sharp rise in long-term interest rates upon a change in the direction of anticipations concerning domestic economic activity, prices, and the Base Rate. In contrast, the yield curve inversion in the later part of 2008 was brought to an end by a much steeper fall in short-term rates than in long-term rates as a result of the Bank of Korea's large-scale reduction of the Base Rate to counter the effects of the global financial crisis.

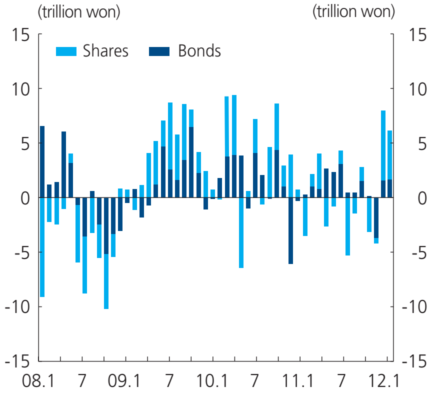
BOX

I-4

Trends of Foreign Portfolio Investment

After continuing net inflows from 2009 onwards (+51.3 trillion won in 2009 and +40.3 trillion won in 2010), foreign portfolio investment in 2011 shifted to a net outflow for the first time since Lehman Brothers' collapse (-35.4 trillion won in 2008) against the backdrop of the worsening external environment including the sovereign debt problems in Europe and worries about the economic slowdown in the US and other advanced countries. The scale of the net outflow of equity investment funds, however, was relatively small compared with 2008 and, bond investment funds[1], in contrast, registered a net inflow, so that the overall net outflow of foreign portfolio investment was not very large (- 0.6 trillion won in 2011).

In- and outflows of foreigners' domestic portfolio investment funds[1]

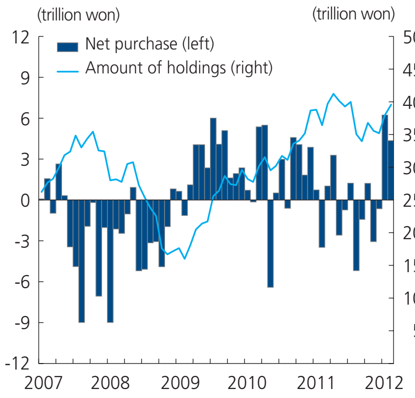


Note: 1) On the basis of net purchases for equities and of changes (increases/decreases) in holdings for bonds.
Sources: Financial Supervisory Service, Koscom Corp.

On the basis of the abundant global liquidity and the favorable corporate performance of domestic firms, foreigners were large-scale net buyers of domestic equities during March and April 2011, but they subsequently turned to net sellers whenever external destabilizing factors emerged, such as those connected with the sovereign debt problems in Europe, so that for the year as a whole they were net sellers to the tune of 9.4 trillion won. The bond market, on the other hand, attracted a net foreign bond investment fund inflow of 8.8 trillion won that was led by Asian central banks. This development is analyzed as resulting from the emergence of a favorable investment environment of the Korean economy because of its comparatively rapid economic recovery trends and fiscal soundness coupled with the diversification of Asian central banks' foreign reserve operations in line with the global environment change, from the latter half of 2009.

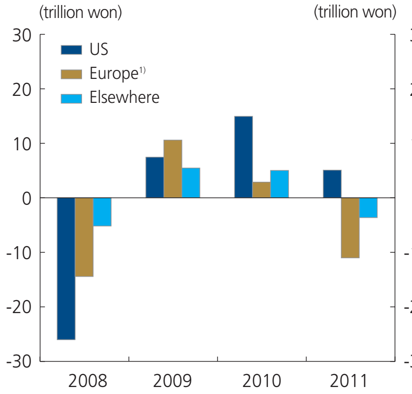
1) In December 2011 foreigners' holdings of domestic debt securities decreased 3.7 trillion won in line with the sluggish roll-over of maturing investments because of year-end closing and the weakening of arbitrage transaction incentives.

In- and outflows foreigners' domestic equity investment funds



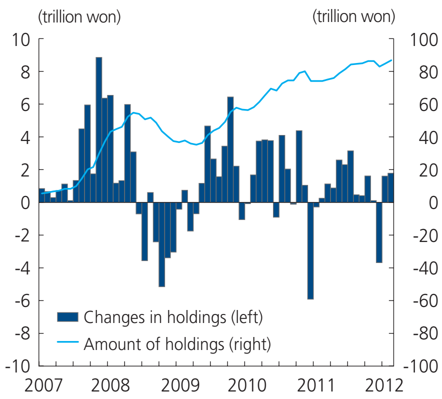
Source: Financial Supervisory Service.

Foreigners' net equity purchases by country



Note: 1) Combined total for the UK, Luxembourg, Ireland, and Germany
Source: Financial Supervisory Service

In- and outflows of foreigners' domestic bond investment funds



Source: Financial Supervisory Service.

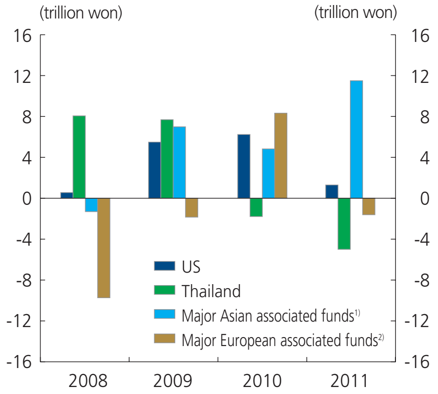
From the beginning of 2012, meanwhile, foreign portfolio investment expanded greatly, being concentrated on the share market, owing to the abundant global liquidity and the soothing of the international financial market unrest.

Breaking down foreigners' domestic share investment by country during 2011, it is apparent that in contrast to the time of Lehman Brothers' collapse, the net selling was led by European-based investors, who were particularly sensitive to the sovereign debt problems in Europe. Nevertheless the scale of European investors' net selling (-11.0 trillion won) was rather smaller than at the time of the 2008 financial crisis (-14.4 trillion won).

In the case of foreigners' bond investment, there was a continuing shift in the character and the objects of the funds. From 2007 to 2009, there were large-scale inflows of primarily Thailand associated funds with a preference for short-term investments seeking arbitrage gains, after which they continually flowed out. From 2009 onwards foreigners' domestic bond investment was led by US and European associated global bond investment funds and by Asian central banks' funds with a strong preference for medium- and long-term horizon investment. In 2011 there were conspicuous inflows of Asian central banks' funds other than from the Bank of Thailand.

Consequently, the objects of investment also changed from short-term Monetary Stabilization Bonds (MSBs) toward long-term Treasury bonds. During 2011 foreigners' investment in Treasury bonds increased by 13.2 trillion won so that their total holdings of Treasury bonds outstanding rose from 15.2% as of end-2010 to 17.5% as of end-2011. On the other hand their investment in MSBs fell by 5.4 trillion won over the same period, bringing a decline in their share of MSBs outstanding from 15.5% to 12.1%.

Changes in foreigners' bond holdings by country



Notes: 1) Combined total for seven countries including Malaysia, Singapore, China (PRC), and Kazakhstan.
2) Combined total for seven countries including France, the UK, Luxembourg and Germany.
Sources: The Bank of Korea, Financial Supervisory Service.

As inflows of medium- and long-term bond investment funds continue, the influence of foreigners has gradually increased not just in the domestic share market but also in the bond market. Foreigners' medium- and long-term bond investment shows a pattern of purchasing specific types of Treasury bonds and holding them for a long period (buy & hold). This serves not only as a factor lowering long-term market interest rates at the time of purchase but also as one exerting continued downward pressure on interest rates by reducing the volume of Treasury bonds in the secondary market. In fact from July 2010 onwards, despite the five-step rise in the Base Rate, yields on Treasury bonds perversely showed a downward pattern owing to supply and demand-related factors including foreigners' net bond purchases.

BOX

I-5

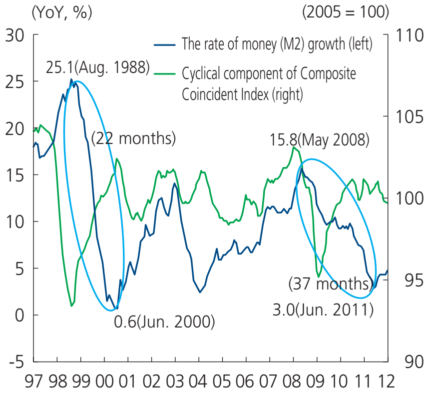
Recent Developments in Money Growth and Liquidity

The year-on-year rate of money (M2) growth continued on a downward trend, even after domestic economic activity exhibited an upward trend from the latter half of 2009 as it had escaped from the influence of the global financial crisis. This was attributable to the lagged adjustment of liquidity provided excessively in comparison with the requirements of real economic activity, following the global financial crisis. A similar situation also happened after the foreign currency crisis.

But as this adjustment process has been to some extent completed, the rate of money (M2) growth has been rising at a modest pace since the latter half of last year, led by private sector credit.

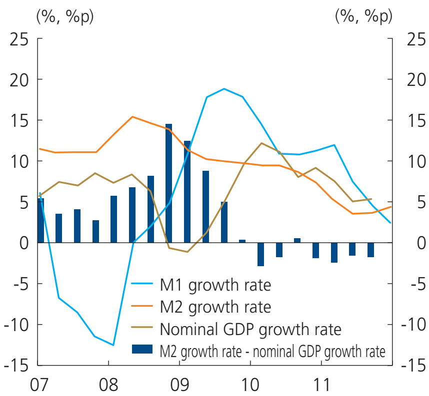
Meanwhile, looking at current liquidity conditions through indicators such as the gap between real M2 and real GDP and the real money gap ratio, it is judged that the level of liquidity is not insufficient to support real economic activity, despite the excess having been reduced by a large margin following the global financial crisis.

The rate of money (M2) growth and cyclical component of Composite Coincident Index



Sources: The Bank of Korea, Statistics Korea.

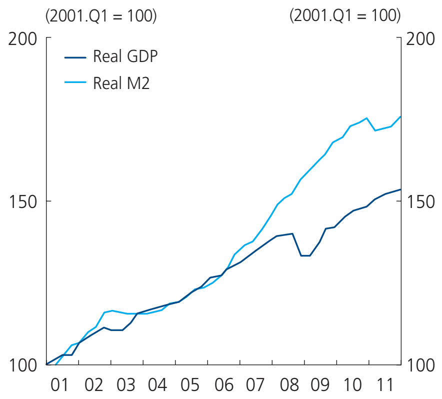
The rates[1] of money growth and nominal GDP



Note: 1) Compared with the same periods of the previous years.
Source: The Bank of Korea.

The gap between real M2 and real GDP widened greatly in response to the contraction of real GDP following the economic downturn after the outbreak of the global financial crisis. Since early 2011 this gap has gradually narrowed but even now real M2 is outstripping real GDP by a comparatively large margin, so that market liquidity appears ample compared with the needs of real economic activity.

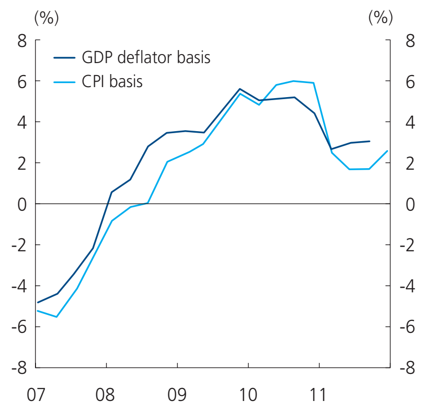
Real M2 and real GDP



Note: M2/CPI and the real GDP are indexed from a base of 2001.Q1 = 100
Source: The Bank of Korea.

Similarly, the real money gap ratio, which shows the degree of divergence between real M2 and its long-term equilibrium, has exhibited a declining trend since the first quarter of 2011, but it is estimated that the real M2 still exceeds its long-term equilibrium.

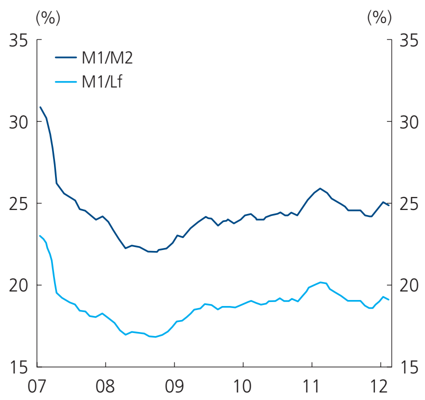
Real money gap ratio[1] (M2 basis)



Note: 1) (Real M2/long-term equilibrium of real M2 - 1)×100
Source: The Bank of Korea.

Meanwhile, both the M1/M2 and the M1/Lf ratios have exhibited downward trends by and large since March 2011 as the excessive liquidity has gradually drained off in the meantime. This indicates that there has been some moderation of the short-termization of market funds.

M1/M2 and M1/Lf ratios[1]



Note: 1) The figures for February 2012 are preliminary.
Source: The Bank of Korea.

BOX
I-6

Developments in Firms' Cash Flow and Fund-Raising

Firms' cash flow resulting from their recurrent activities (hereinafter cash flow is calculated as the difference between cash inflow from operating activities and cash outflow from investing activities, which is termed "firms' cash flow") showed a pattern of a widening deficit. During the first nine months of 2011, firms' cash flow deficit was the largest in scale since 2009 and the size of the deficit widened much more greatly for large firms than for SMEs.

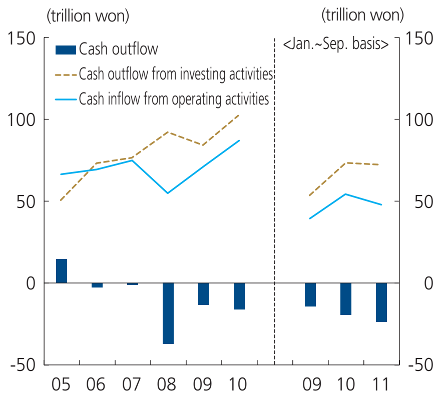
Firms' cash flow[1]

(trillion won)

	All firms	Large firms	SMEs
Jan.~Sep. 09	-14.3	-12.6	-1.6
Jan.~Sep. 10	-19.5	-16.7	-2.7
Jan.~Sep. 11	-23.8	-21.2	-2.6
Q1	-4.0	-2.7	-1.4
Q2	-10.1	-9.3	-0.8
Q3	-9.6	-8.9	-0.7

Note: 1) On the basis of firms listed on the KRX securities market or KOSDAQ market whose financial statements are registered with KIS-Value as of the end of February 2012.
Source: KIS-Value.

Firms' cash flow



Source: KIS-Value.

Factors causing changes in firms' cash flow[1]

(trillion won, %)

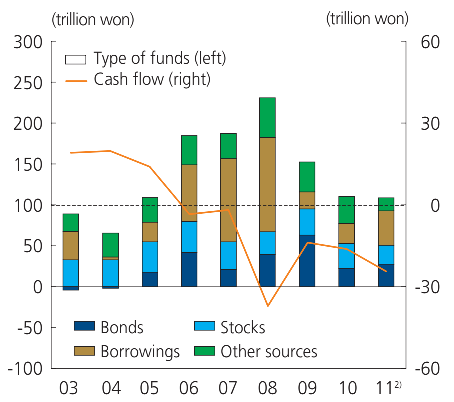
	09.Q1 ~Q3	10.Q1 ~Q3	11.Q1 ~Q3
Amount of inflows from operating activities	0.6	14.2	-5.5
(Net profit)[2]	-8.4	24.5	-14.3
(Sales receivables)[3]	-1.7	2.8	5.2
(Inventory assets)[3]	32.7	-20.9	-2.9
(Advance received or account payable)[3]	-22.6	7.7	4.6
Cost of sales/sales revenue	81.6	79.3	81.6

Notes: 1) Compared with the same periods of the previous years ((+) indicates increase in cash flow, (-) indicates decrease in cash flow).
2) Adjustment for foreign currency translation gain and loss not causing actual cash in- and outflow.
3) Increase (decrease) in sales receivables and inventory assets is the factor of decrease (increase) in cash flow and increase (decrease) in advance received and account payable is the factor of increase (decrease) in cash flow.
Source: KIS-Value.

Generally, a worsening of firms' cash flow results from the effect of reduced profitability due to rising costs, an expansion of in inventories and sales receivables, or increasing in investment expenses. During the first nine months of 2011 the widening scale of firms' cash flow deficit was mainly attributable to worsening profitability. During this period, cash outflow from investing activities generally stayed at the same level as the year before, but cash inflow from operating activities declined as net profit narrowed sharply because of the rise in the cost of sales owing to the sharp run-ups in international commodity prices.

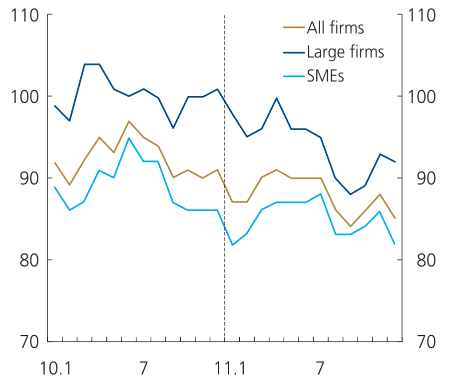
Generally, an expansion of firms' cash flow deficit gives rise to enlarged demand for external fund-raising in the financial markets. When domestic firms in Korea experience a cash-flow deficit, they tend to make good the lack of funds through borrowings from financial institutions, rather than employing direct financing methods such as the issue of bonds. In fact, domestic firms greatly increased their external fund-raising with a focus on financial institution borrowings when cash flow deteriorated during 2007-2008. Similarly, in the first nine months of 2011, they expanded their borrowings from financial institutions in response to the increased scale of funds shortages. During the first nine months of 2011, the overall scale of domestic firms' fund-raising increased by 9.9 trillion won from the same period of the previous year (98.8 trillion won) to stand at 108.7 trillion won. In particular, borrowings from financial institutions almost doubled from the same period of the previous year (23.0 trillion won) to reach 41.1 trillion won. In this situation, the perceived financial conditions of both large firms and SMEs showed a deteriorating pattern.

Firms' cash flow and fund-raising by type[1)]



Note: 1) On the basis of non-financial corporations as defined in the flow of funds statistics.
2) During Jan. ~ Sep. 2011.
Sources: The Bank of Korea, KIS-Value.

Financial condition BSI in the manufacturing industry



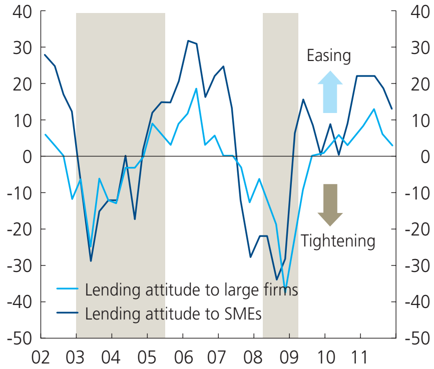
Source: The Bank of Korea.

Going forward, similarly, for some time there is the possibility that the cash-flow deficit of domestic firms will widen and their financial conditions worsen. Generally if economic activity is slackening, firms' cash flow from operating activities deteriorates[1)] because of reduced sales, and increased inventories and sales receivables. During 2012, because domestic economic

1) In fact from the first quarter of 2003 to the third quarter of 2011, there was a correlation of 0.36 lagged by one quarter between the rate of changes in domestic firms' cash flow and the growth rate of Korean GDP as the rate of changes in cash flow led the GDP growth rate.

activity is seen to slacken owing to the high degree of global economic uncertainty arising from the sovereign debt crisis in Europe, it is likely that firms' cash flow will deteriorate. Furthermore, there is the possibility that the instability of international commodity prices because of geopolitical factors such as the economic sanctions against Iran could continue to act by way of 「rise in cost of sales → decline in profitability」 as a factor worsening firms' cash flow. Meanwhile, firms' financial conditions may worsen as the demand for borrowings increases owing to the deterioration of cash flow in this way. In particular, during periods of economic downturn, financial institutions' attitude toward lending tends to become harsher. Added to this, if large firms increase their borrowings from financial institutions, the latter's scope for further lending declines so that it may well lead to fund-raising bottlenecks for SMEs.

Banks' lending attitude during economic downturns



Note: Shaded areas are times of contraction of economic activity.
Source: The Bank of Korea.

Changes in inventory assets and sales receivables by phase of the business cycle[1)]

(%, million won)

	Period of economic upturn	Period of economic downturn
Sales receivables[2)]	4.3	8.9
Inventory assets[2)]	3.3	8.5
Cash flow from operating activities[3)]	4,968	-2,539

Notes: 1) During the year of 1995-2010.
2) The rate of the increase compared with the previous months, period average basis.
3) The amount of the increase compared with the previous months, firm average basis.
Source: KIS-Value.

BOX

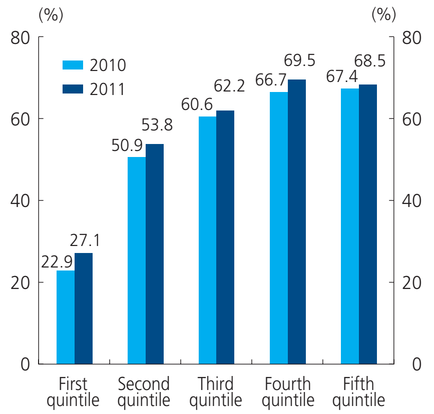
I-7

Status of Household Debt Based on the 'Survey of Household Finances in 2011'

The results of the 'Survey of Household Finances in 2011', a survey based on a sample of 10,517 households nationwide, jointly carried out by Statistics Korea, the Financial Supervisory Service, and the Bank of Korea, were released on November 11, 2011. The survey was undertaken for the first time in 2010 to gain an accurate grasp of Korean households' financial soundness including the status of asset and liabilities and that of income and expenditures, and this was the second of such surveys.[1)]

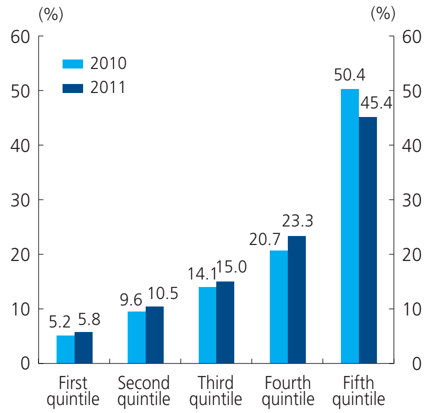
The survey population was basically the same as that of the previous year and it was compiled on the basis of assets and liabilities as of end-March 2011 and income and expenditures during 2010. Making use of the micro-data found by this survey, the distribution of household debt and changes in the household debt service burden can be understood. Firstly, according to the 'Survey of Household Finances in 2011', the proportion of households with financial debts had increased from the previous year (53.7%) to 56.2%. The number of indebted households had increased among all income groups

Proportion of indebted households by income quintile[1)]



Note: 1) Proportion to all households within the relevant quintile.

Distribution of household debt by income quintile[1)]



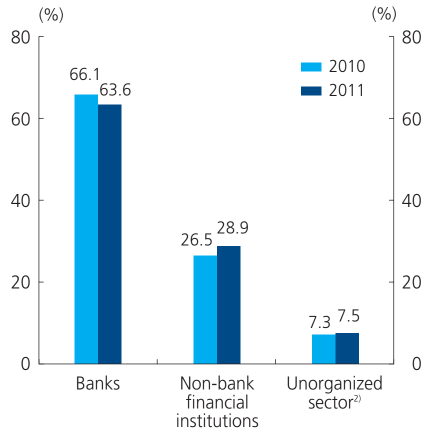
Note: 1) On the basis of the amount of financial liabilities.

1) Of the panel (10,000 households) surveyed in 2010, 8,918 households were retained, and 1,599 households were substituted or newly added. The date of the basis for the reporting of assets and liabilities was changed from the end of February (2010 survey) to the end of March (2011 survey).

while the scale of the increase was relatively large for those in the lowest income group (first quintile). Nevertheless the proportion of indebted households in the lowest income group still stood at a very low level compared with other income groups. In terms of the distribution of household debt by income quintile, as in the previous year, those with a comparatively greater capacity to repay their debt (fourth and fifth quintiles) held some 69% of total household debts. Looking at the changes in the proportion of households with liabilities by dividing the population into five income quintiles, the proportion of households with liabilities in the highest income group (fifth quintile) narrowed whereas it increased for all other income groups, albeit slightly. This was attributable to the fact that the scale of the liabilities of the highest income group had not changed greatly over the previous one year whereas it had risen by a large margin for all other income groups.

In terms of the distribution of household debt by borrowing institution, borrowings from banks at 63.6% made up the largest proportion in terms of total value although this figure had narrowed by 2.5 percentage points compared with one year earlier whereas the proportion of borrowings from non-bank financial institutions had increased. This indicated that the quality of household debt had worsened as there had been a rapid increase in the liabilities of those in the lowest income groups that have a relatively heavy dependence on borrowings from non-bank financial institutions. Breaking down borrowings in terms of use, once again as in the previous year about half of total household debt incurred was for the purchase of real estate and the proportion for business use exhibited the second-highest level. Dividing the population in terms of income quintile, by and large the higher the income, the greater

Distribution of household debt by borrowing institution[1)]



Notes: 1) On the basis of the amount of secured and credit loans.
2) Workplace, benefit association, private loans, specialized loan business, etc.

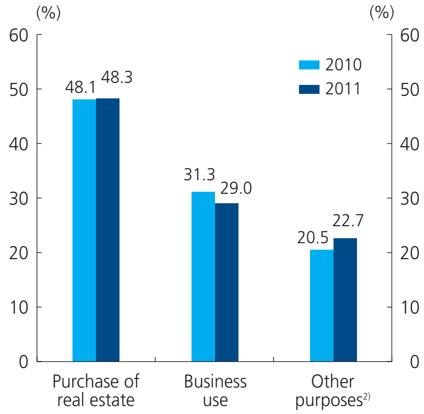
Distribution of household debt by income quintile and purpose of borrowing (2011)

(%)

	First quintile	Second quintile	Third quintile	Fourth quintile	Fifth quintile
Purchase of real estate	23.3	47.2	45.4	51.7	50.9
Business use	22.0	23.1	25.1	24.9	34.5
Other purposes (living expense)[1)]	54.7	29.7	29.5	23.5	14.6

Note: 1) To raise funds in preparation for leasehold or rental deposits, wedding expenses, medical costs, tuition, living expenses, debt repayment, etc.

Distribution of household debt by purpose of borrowing[1)]



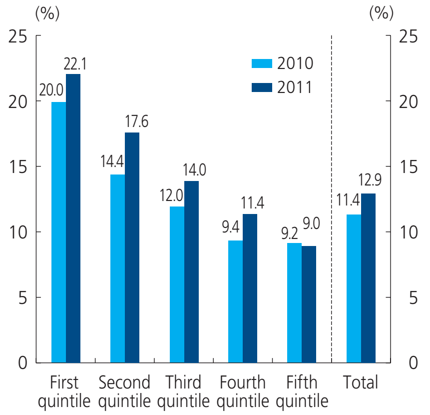
Notes: 1) On the basis of the amount of secured and credit loans.
2) To raise funds in preparation for leasehold or rental deposits, wedding expenses, medical costs, tuition, living expenses, debt repayment, etc.

the proportion for the purchase of real estate and business use, while there was a pattern of the proportion for living expenses being higher, the lower the income.

Meanwhile, the debt service ratio (DSR = the ratio of debt service payments, which consist of principal and interest, to median income) of indebted households rose from 11.4% of the previous year to 12.9%. In terms of income groups, apart from those in the highest income group (fifth quintile), there was a 2-3 percentage point jump from the previous year in the DSR for all income groups. Together with the increase in households' debt service burden, the proportion of heavily-indebted households (DSR greater than 40%) to the population rose by some two percentage points for all income groups, apart from those in the highest income group (fifth quintile), so that there was a rise in this proportion from 7.8% to 9.9% as a whole.

The rise both in households' debt service burden and in the proportion of heavily-indebted households during 2011 is ascribed in large part to the commencement of the repayment of principal on mortgage loans, which had previously been on an interest-only basis. The redemption of principal on mortgage loans, which had increased substantially during the period of rising house

Debt service ratio of indebted households by income group[1)]



Note: 1) On the basis of the median value for the relevant quintile.

Distribution of the maturity or the end of deferment periods of mortgage loans

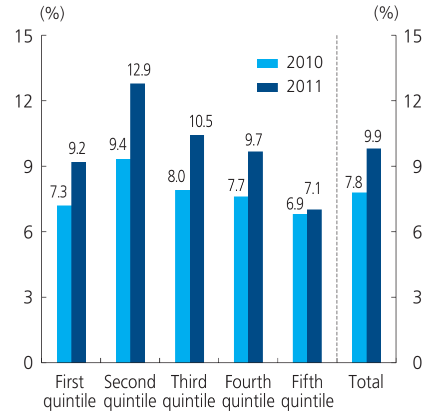
(%)

2011	2012	2013	2014	2015	2016	2017 or later[1)]
19.3	25.6	20.5	8.7	5.8	3.6	16.4

Note: 1) Includes those households whose loan maturity or ending of deferment periods cannot be classified among multiple creditors having taken out two or more collateralized loans.

prices prior to the global financial crisis, began in earnest from last year. In particular, vigilance should be exercised as the burden of principal payment will increase greatly in the coming years with some 46% of total mortgage loans (value basis) falling due or ending their deferment periods during 2012-13.

Proportion of households with DSR> 40% by income group[1)]



Note: 1) Proportion to all households within the relevant quintile.

D. Foreign Exchange Market

(1) Exchange Rates

The Korean won/US dollar exchange rate, after falling to 1,050.0 won per US dollar on July 27, 2011 thanks to the continued buoyancy of exports, shifted to an upward trend from August onwards due to the downgrade of US sovereign credit rating and concerns over the spread of the sovereign debt problems in Europe, and it registered 1,195.8 won as of September 26. It subsequently dropped by a large margin as the fears concerning the euro area crisis eased and bilateral Korea-Japan and Korea-China currency swap arrangements were announced, before fluctuating in response to the evolution of the euro area crisis. From the beginning of 2012, it dropped slightly amid the soothing of international financial market unrest helped by the ECB's provision of long-term liquidity to stand at 1,118.7 won per US dollar as of end-February 2012, having depreciated 4.6% compared with the end of June 2011.

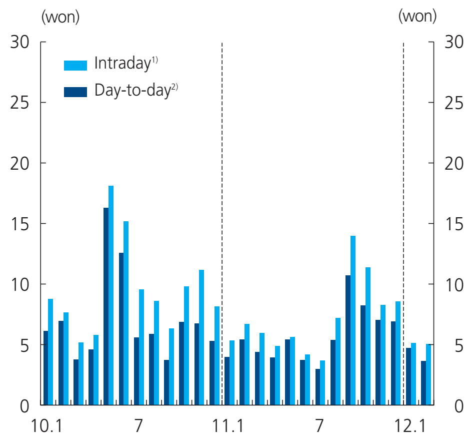
The Korean won/Japanese yen exchange rate rose steeply in line with the strengthening trend of the Japanese yen against the US dollar because of the international financial market unrest and the US Federal Reserve's continued accommodative monetary policy stance. The Korean won traded at 1,393.2 won per 100 yen as of the end of February 2012, having depreciated 4.7% against the yen since the end of June 2011.

<Figure I-44> Major exchange rates[1]

Notes: 1) Closing-rate basis.
2) The basic foreign exchange rate offered to customers posted by Korea Exchange Bank.
Sources: Korea Money Brokerage Corp., Seoul Money Brokerage Services Ltd., Korea Exchange Bank.

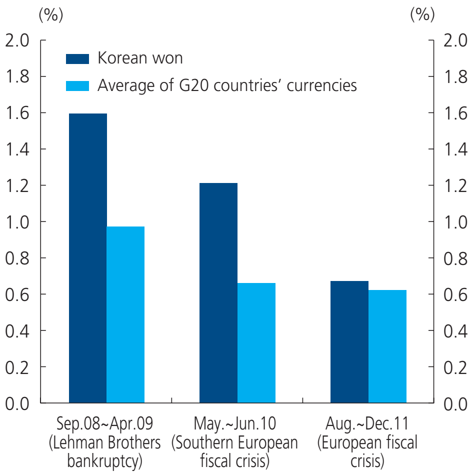
Both the intraday and the day-to-day volatility of the won/dollar exchange rate widened greatly from early August 2011 and, after registering a peak in September, exhibited a gradually narrowing pattern. At the same time there was a great moderation of the phenomenon whereby the Korean won/US dollar exchange rate exhibited a relatively high degree of volatility compared with that of other currencies against the US dollar at times of international financial market unrest. During the last five months

<Figure I-45> **Exchange rate (₩/US$) fluctuations**



Notes: 1) Averages of 'the intraday highest rate minus the intraday lowest rate'.
2) Averages of the absolute value of 'the day closing rate minus the previous day closing rate'.
Sources: Korea Money Brokerage Corp., Seoul Money Brokerage Services Ltd.

<Figure I-46> **Volatility[1] of exchange rate of Korean won and G20 countries' currencies[2] against the US dollar**



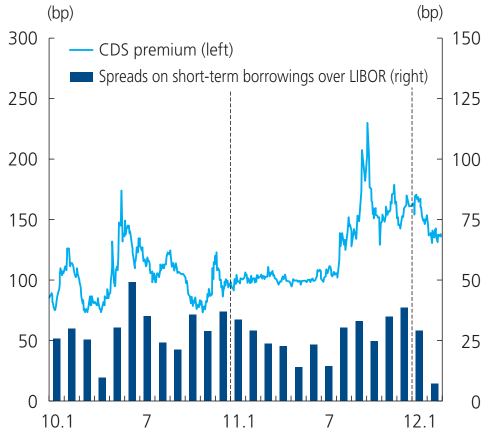
Notes : 1) Average of the absolute value of the day-to-day change rate during the period. Those of G20 are the simple averages of their volatility of exchange rate.
2) 14 countries basis excluding Korea, US, Saudi Arabia (pegged to US dollar), and countries using euro as their currency (Germany, France, Italy).
Sources : The Bank of Korea, Bloomberg.

of 2011, the difference of the day-to-day volatility between the Korean won and other G20 countries against the US dollar (0.05 percentage points) narrowed compared with that during the episodes of international financial market unrest in 2008 and 2010 (0.62 percentage points and 0.55 percentage points respectively).

(2) Overseas Borrowing Conditions

Overseas borrowing conditions worsened from August 2011 onwards due to the expansion in external destabilizing factors, but they picked up somewhat from January this year with the mitigation of international financial market unease. The foreign

<Figure I-47> **Spreads[1] on Korean banks' short-term borrowings and CDS premium[2]**



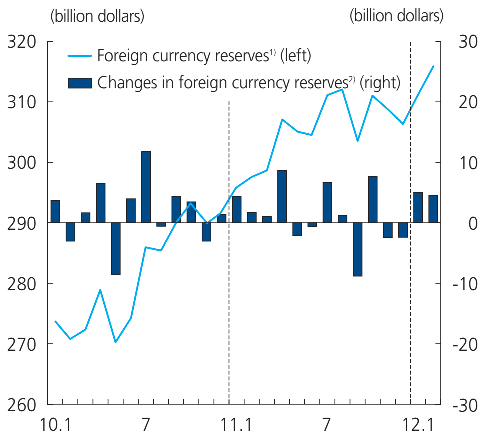
Notes: 1) Spreads on Korean banks' short-term borrowings over LIBOR; period-average.
2) Foreign Exchange Stabilization Fund Bonds (5-year).
Sources: The Bank of Korea, Bloomberg.

currency funding conditions of domestic banks appeared favorable by and large, owing to their efforts to secure foreign currency liquidity in advance against external uncertainty and to inflows of medium- and long-term funds borrowed overseas. The Korean CDS premium (5-year maturity) rose to 229 basis points on October 4 upon the strengthening of global risk aversion preferences because of the spread of the sovereign debt problems in Europe. It subsequently changed course to a decline that brought it to stand at 136 basis points as of the end of February 2012. The spread on domestic banks' short-term borrowings similarly exhibited an upward trend and, from early this year, fell back to stand at 7 basis points as of February 2012, which was 16 basis points lower than in the end of June 2011.

(3) Foreign Currency Reserves

The foreign currency reserves increased by 11.3 billion dollars compared with the end of June 2011 to register 315.8 billion dollars at the end of February 2012 owing to earnings from the operation of foreign currency reserve holdings acting to more than offset the reduced dollar translation value of assets denominated in other currencies in line with the euro's weakening trend. In order to diversify investment assets, the Bank of Korea purchased a total of 40 tons of gold during the latter half of 2011. As of the end of February, the foreign currency reserves consisted of securities valued at 289.5 billion dollars (91.7%), deposits of 18.0 billion dollars (5.7%), SDRs of 3.6 billion dollars (1.1%), the country's IMF reserve position of 2.6 billion dollars (0.8%), and 2.2 billion dollars in gold (0.7%).

<Figure I-48> Foreign currency reserves



Notes: 1) Month-end basis.
2) Compared with the previous months.
Source: The Bank of Korea.

(4) Foreign Credits and Liabilities

As of the end of December 2011, claims on the rest of the world stood at 496.4 billion dollars, which was 10.0 billion dollars higher than at the end of June that year. In terms of maturity, short-term claims on the rest of the world increased by 10.2 billion dollars and long-term claims shrank by 0.2

billion dollars.

The outstanding balances of external liabilities stood at 398.4 billion dollars at the end of December 2011, a decrease of 0.9 billion dollars compared with the end of June that year. In terms of maturity, short-term liabilities had contracted 17.8 billion dollars over that same period whereas long-term liabilities had increased by 16.9 billion dollars. Consequently, as of the end of December 2011, the weight of short-term external liabilities (short-term external liabilities/total external liabilities) had declined 4.3 percentage points from the end of June (38.5%) to stand at 34.2%.

In terms of sector, the external liabilities of general government and the monetary authorities declined by 1.0 billion dollars and 4.5 billion dollars, respectively, because of the collection of foreigners' holdings of Treasury bonds and MSBs. Similarly, the external liabilities of deposit-taking institutions fell by 2.5 billion dollars over the same six-month period. In contrast, the other sector's external liabilities, which include those of private firms, increased by 7.1 billion dollars because of firms' issue of foreign-currency denominated securities.

The net international investment position, measured by the subtraction of external liabilities from external claims, stood at 98.0 billion dollars as of the end of December 2011, increasing by 10.8 billion dollars compared with the end of June that year.

<Table I-17> **Foreign credits and liabilities[1]**

(billion dollars, %)

	2010	2011[p]			
		Q1	Q2	Q3	Q4[p]
External assets	451.0	469.5	486.4	493.8	496.4
Short-term	374.2	388.1	398.9	409.2	409.1
Long-term	76.9	81.3	87.5	84.6	87.2
External debt	359.4	382.4	399.3	395.6	398.4
<By maturity>					
Short-term[2]	139.8	153.6	153.9	139.9	136.1
	(38.9)	(40.2)	(38.5)	(35.4)	(34.2)
Long-term	219.7	228.8	245.4	255.7	262.3
<By sector>					
General government	44.4	48.1	54.5	52.0	53.5
Monetary authorities[3]	35.6	34.6	34.9	33.7	30.5
Banks	173.1	189.9	196.5	192.2	194.1
Other sectors[4]	106.4	109.8	113.3	117.8	120.3
Net external assets	91.6	87.1	87.2	98.2	98.0

Notes: 1) Period-end basis.
2) The figures in parentheses refer to the ratio of short-term external debt to total external debt.
3) The Bank of Korea and the Foreign Exchange Stabilization Fund.
4) Non-bank financial institutions, public corporations, private firms, etc.
Source: The Bank of Korea.

II

Conduct of Monetary Policy

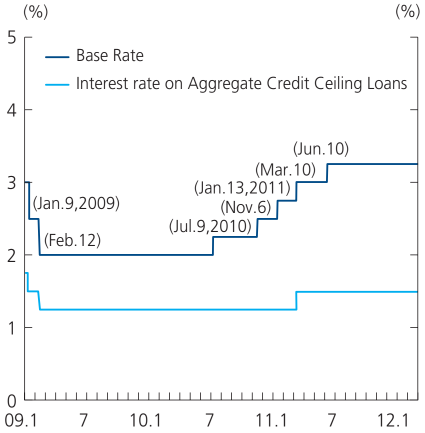
1. Base Rate 71
2. Other Monetary and Credit Policies 75
3. Policies for Financial Market Stability 79

1. Base Rate

The Bank of Korea, closely monitoring financial and economic risk factors both at home and abroad, conducted its monetary policy from the latter half of 2011 with an emphasis on ensuring that the basis for price stability was firmly anchored while the economy continued its sound growth.

In keeping with this policy stance, the Bank maintained the Base Rate at 3.25% and the interest rate on its Aggregate Credit Ceiling Loans at 1.50%.

<Figure II-1> **Bank of Korea Base Rate and interest rate on Aggregate Credit Ceiling Loans**



Source: The Bank of Korea.

Base Rate Kept Unchanged at Existing Level from July 2011

The rationale for maintaining the Base Rate at 3.25%, even despite the continued high rate of increase in the consumer price index (CPI) during this period, was that the downside risks to growth and volatility of the financial and foreign exchange markets had expanded, due for example to the sovereign debt problems in Europe, the slowdown of major economies, and international financial market unrest, while it was expected that the upward pressures on prices would ease somewhat in 2012.

In the world economy, first of all, the trend of recovery had shown signs of faltering as the negative impacts on the real economy of the continued deterioration of the sovereign debt problems in Europe during the latter half of 2011 have spread to emerging market countries. In addition the international financial markets exhibited a highly unstable pattern from August 2011 onwards, owing to the downgrade of the US sovereign credit rating and the worsening of the sovereign debt problems in Europe. Share prices and long-term interest rates plunged together, and credit spreads widened, in line with a heightening of the preference for safe-haven assets and the strengthening of financial institutions’ efforts to secure liquidity. The market unrest gradually eased from late December, however, thanks to the ECB’s large-scale provision of long-term liquidity.

<Table II-1> **Changes in outlook for world economic growth by IMF[1)]**

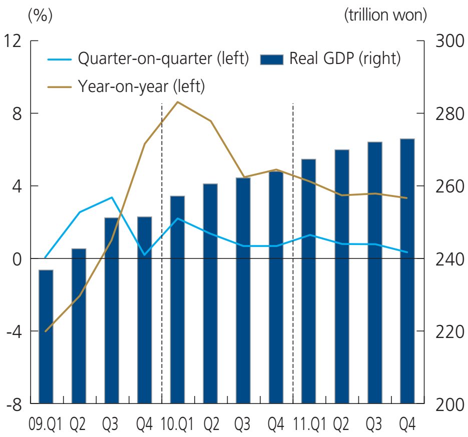
(%, %p)

	2010	2011[e]	2012[e]
World	5.2	3.8 (-0.2)	3.3 (-0.7)
Advanced economies	3.2	1.6 (0.0)	1.2 (-0.7)
(US)	3.0	1.8 (+0.3)	1.8 (0.0)
(Euro area)	1.9	1.6 (0.0)	-0.5 (-1.6)
(Japan)	4.4	-0.9 (-0.4)	1.7 (-0.6)
Emerging and developing economies	7.3	6.2 (-0.2)	5.4 (-0.7)
(China)	10.4	9.2 (-0.3)	8.2 (-0.8)

Note: 1) Figures in parentheses are the increases/decreases in outlook data compared with previous ones (Sep. 2011).
Source: IMF, World Economic Outlook Update, Jan. 2012.

Looking at the domestic economy, its trend of growth showed signs of a slowdown in the second half of 2011, amid the mounting uncertainties as to external conditions including the sovereign debt problems in Europe. Real GDP growth

<Figure II-2> **Real GDP growth rate**

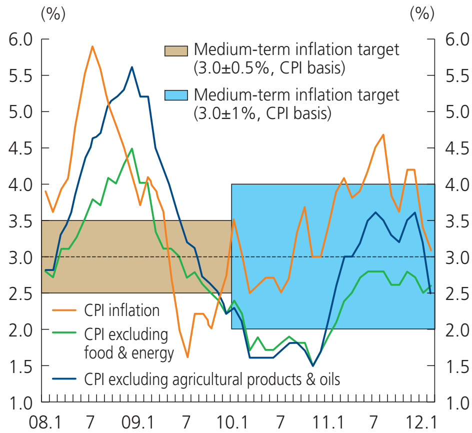


Source: The Bank of Korea.

(quarter-on-quarter), after running at 0.8% (3.6% year-on-year) in the third quarter, fell to 0.3% (3.3% year-on-year) in the fourth quarter, as exports and domestic demand declined owing to the slowdown of world economic growth and the drop in both consumer and investment sentiment. Economic activity remained subdued from early 2012, as well. Furthermore, against the backdrop of the outflow of foreigners' equity investment funds owing to the sovereign debt problems in Europe and the international financial market unrest, there was a great expansion of volatility with share prices falling steeply and the won/dollar exchange rate climbing sharply.

After registering 4.7% in August 2011, consumer price inflation (year-on-year) gradually fell, owing to the slackening of domestic economic activity and the stability of agricultural and livestock product prices, but nevertheless it still exhibited a high level of around 4%. The rate of core inflation also maintained a high level, as supply shocks due, for example, to the run-up in international oil prices were passed through with some time-lag to drive up the prices of other commodities. From the beginning of this year, both consumer price inflation and core inflation exhibited a pattern of deceleration mainly due to a base effect. As

<Figure II-3> CPI and core inflation[1]



Note: 1) Compared with the same months of the previous years.
Source: Statistics Korea.

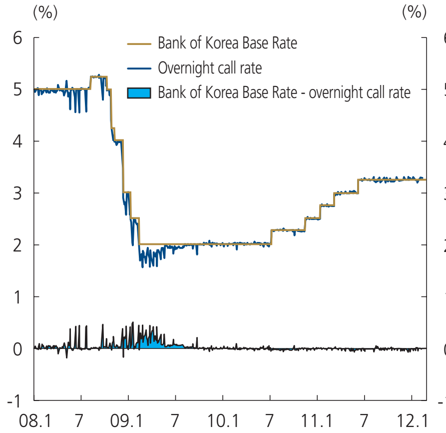
estimated through the Bank of Korea's regular survey of economic agents, inflation expectations have meanwhile shown only a slow retreat from their high level of between around 3.5% and slightly over 4.0%.

The Bank of Korea deemed that the effect on inflation of supply shocks such as the run-up in international commodity prices and abnormal weather conditions would be short-lived, whereas there was great uncertainty as to the course of growth and the possibility of domestic financial and foreign exchange market unrest generated by external risk factors. Consequently it continued to maintain the Base Rate at its existing level while monitoring even more closely the evolution of financial and economic conditions.

Liquidity Adjustment to Bring the Call Rate to the Level of the Base Rate

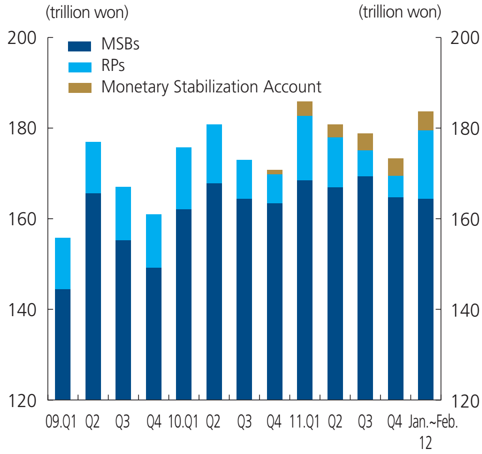
The Bank of Korea undertook the adjustment of market liquidity by means of open market operations such as sales of securities under repurchase agreements (RPs), the issue of Monetary Stabilization Bonds (MSBs), and the operation of the Monetary Stabilization Account by means of competitive interest rate tenders for deposits, in order to bring about the convergence of the call rate with the level of the Base Rate set by the Monetary Policy Committee. In the course of this liquidity adjustment, the outstanding of MSBs, which are used for structural adjustment, declined by 2.4 trillion won from 167.0 trillion won at the end of June 2011 to 164.6 trillion won at the end of February 2012. This was because the supply of liquidity through the government sector narrowed in the latter half of the year because of the government's redemption of its borrowings from the Bank of Korea in line with the reduced call for budget disbursement. It was also attributable to the enlarged resort to such other liquidity adjustment instruments as sales of RPs and the Monetary Stabilization Account in order to rein in the accumulation of the outstanding of MSBs.

<Figure II-4> Bank of Korea Base Rate and overnight call rate



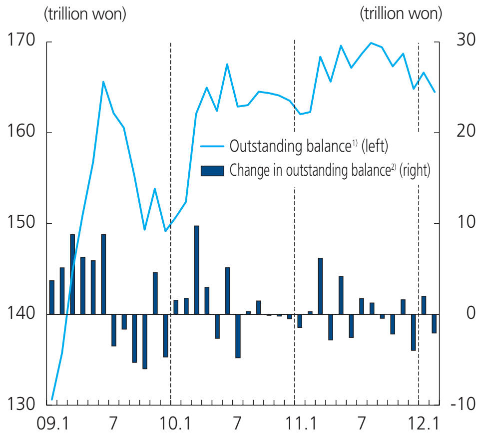
Source: The Bank of Korea.

<Figure II-6> Scale of liquidity adjustment by means of open market operations



Source: The Bank of Korea.

<Figure II-5> Outstanding balance of MSBs



Notes: 1) Month-end basis.
2) Compared with the previous months.
Source: The Bank of Korea.

2. Other Monetary and Credit Policies

The Bank of Korea improved the operating framework of monetary and credit policies by, for example, introducing a securities lending facility and revising reserve requirement system, in reflection of the revised Bank of Korea Act and its enforcement decree, which came into effect from December 17, 2011. Meanwhile the system of Aggregate Credit Ceiling Loans was improved in order to enhance the effectiveness of financial institutions' support for SMEs.

Reorganization of Reserve Requirement System

The Bank of Korea drew up the regulations for imposition of reserve requirements on certain types of financial bonds, while revising the periods of calculation and maintenance of required reserves.

The Bank revised related regulations providing the basis for the imposition of reserve requirements on Korean-won denominated financial bonds with a maturity of less than two years, which are included in liabilities subject to reserve requirements in accordance with the revised Bank of Korea Act. However, the reserve requirement ratio on financial bonds was not established at this stage so as to allow the imposition of reserve requirements on them[10] to be limited to periods of pronounced monetary expansion or where there are concerns of its occurrence.

In addition, for financial institutions' flexible management of their assets, the calculation period and the maintenance period for required reserves were changed from the previous half-monthly to monthly with effect from January 2012. Consequently

<Table II-2> **Reserve requirement ratio by deposit type**

Deposit type	Reserve Requirement Ratio
Worker's Asset Formation Deposits, Worker's Long-Term Savings Deposits, Worker's Housing savings Deposits, Long-Term Housing savings Deposits, Long-Term savings Deposits for Household, and Worker's Preferential Savings Deposits	0%
Time deposits, installment savings deposits, mutual installment deposits, housing installment deposits, certificates of deposit (CD)	2%
Other deposits including demand deposits and money market deposit accounts (MMDA)	7%

Source: The Bank of Korea.

10) Article 12-2 of the Enforcement Decree of the Bank of Korea Act, "Liabilities defined by the Presidential Decree" provided for in Paragraph (1) of Article 55 of the Act refer to the liabilities arising from the issuance of the following Korean-won denominated bonds with a maturity (referring to the maturity set at the time of issuance of the respective security) not exceeding two years from the date of issuance.
1. Financial bonds prescribed in Article 19 of the Enforcement Decree of the Banking Act which are issued during the period when the Monetary Policy Committee considers it necessary to maintain reserves referred to in Paragraph (1) of Article 55 of the Act, as in a period of pronounced monetary expansion or where there are concerns of its occurrence. ... (remainder omitted)

each financial institution should maintain minimum reserve requirements, calculated on the basis of the average value of their total liabilities subject to reserve requirements from the first day of each month until the last day, from the second week of the following month until the Wednesday of the second week of the month thereafter.

<Table II-3> **Changes in a period of calculation and maintenance of minimum required reserves**

	Before revision	After revision
Period of calculation	The first half of the month: from the first to the fifteenth day of the month The second half of the month: from the sixteenth to the last day of the month	From the first to the last day of the month
Period of maintenance	The first half of the month: from the Thursday of the second week to the Wednesday of the fourth week The second half of the month: from the Thursday of the fourth week of the next month to the Wednesday of the second week of the month after that	From the Thursday of the second week of the next month to the Wednesday of the second week of the month after that

Source: The Bank of Korea.

Meanwhile, in a step to supplement the changes in the reserve requirements, to discourage the postponement until the last day of the adjustment of funds to meet financial institutions' shortages or excesses of reserves, the existing interest rate for liquidity adjustment deposits and loans (Base Rate ± 0.5%p) was changed[11] to a uniform level with that at normal times (Base Rate ± 1.0%p). The implementation date for this was set as February 9, 2012, the commencement date of the period of reserve maintenance on a monthly basis.

<Table II-4> **Changes in interest rate for liquidity adjustment deposits and loans**

Before revision		After revision
• Normal times Base Rate ± 1.0%p • The last day of the maintenance period for required reserves Base Rate ± 0.5%p	→	Base Rate ± 1.0%p

Source: The Bank of Korea.

Improvement Plan Drawn up for Aggregate Credit Ceiling Loans to Encourage Expansion of Banks' Credit Loans to SMEs

The Bank of Korea set up a 'Special Support Ceiling Linked to Credit Loans to SMEs' within the Aggregate Credit Ceiling which brings into effect on April 2, 2012, to induce financial institutions to extend credit loans to SMEs with little capacity to obtain credit on the basis of collateral.

11) A different interest rate from normal times on liquidity adjustment deposits and loans had been applied on the last day of the maintenance period for required minimum reserves. This had initially served to guard against the possibility that the burden of managing reserve requirements would increase excessively in the early stages of the March 2008 reorganization of the monetary policy framework.

The ceiling on the supply of funds was set at 1 trillion won and it is intended to allocate this in accordance with the loan performance of each financial institution. The loans eligible for support are confined to financial institutions' credit loans extended to SMEs solely on a credit basis and whose entire amount is not secured against collateral or guaranteed, but in the case of very small-scale SMEs with low credit ratings, acknowledging their potential difficulties in accessing purely credit loans, loans guaranteed by a business partner and those carrying a personal guarantee are to be included. The loan performance forming the basis for allocation of the ceiling is also to be calculated on the basis of the net increase amount rather than the outstanding balance in order to heighten effectively the incentives for financial institutions to handle such loans.

Meanwhile, the 'Special Support Ceiling Linked to the SME Fast Track Program', introduced and brought into operation straight after the outbreak of the global financial crisis, was abolished on April 2, 2012, and at the same time it was decided to call in the entire 1 trillion won related to the support of the ceiling.

<Table II-5> **Aggregate Credit Ceiling and funds eligible for the support**

(trillion won)

	Ceiling	Funds eligible for support
• Financial Institutions		
·3 types of funds	1.5	Corporate procurement loans, electronically-processed secured receivables loans, and trade financing
·Special Support Ceiling Linked to Credit Loans to SMEs (newly introduced)[1]	1.0	Credit loans to SMEs
·Special Support Ceiling Linked to the SME Fast Track Program (abolished)[1]	1.0	Performance of SME Fast Track Program
• Regional branches	4.9	Regional branches decide the ceilings considering characteristic of each region
• Retained reserve	0.1	—
Total	7.5	—

Note: 1) Implemented on April 2, 2012.
Source: The Bank of Korea.

Effort to Promote 91-Day MSBs As the Benchmark Short-Term Bond

The Bank of Korea stepped up its efforts to issue 91-Day Monetary Stabilization Bonds (MSBs) on a regular basis following on from the decision to promote short-term MSBs as the benchmark short-term bond, which was one of the proposals agreed between the Bank and the government in July 2010 for improving the short-term financial markets. From September 2011 the scale of the regular issue of 91-Day MSBs was enlarged from 1.0 trillion won a week to the 1.2 trillion won level, and from November the expansion of secondary market transactions was encouraged by stepping up the repurchase of bonds with a remaining time to maturity of three months. As a result, 91-Day MSBs strengthened their position as the benchmark short-term bond including the enhancement of their liquidity.

3. Policies for Financial Market Stabilities

The Bank of Korea continued its policy efforts to withdraw the liquidity it had provided during the global financial crisis and to ensure financial stability.

Continued Efforts to Withdraw the Liquidity Supplied during the Financial Crisis

The Bank of Korea withdrew the outstanding balance of its support provided to the Bond Market Stabilization Fund, and also consistently reduced the amount provided in support of the Bank Recapitalization Fund.

From March 2011, the Bank gradually withdrew the support funds for the Bond Market Stabilization Fund by means of the purchase of RPs following the sale of credit-risk bearing bonds held by the Fund, and withdrew the outstanding balance on December 5.

In tandem with this, during December, 1.5 trillion won was collected by buybacks of hybrid bonds held by the Bank Recapitalization Fund.

<Table II-6> **Liquidity provisions to the institutions financed by the Bond Market Stabilization Fund**

(billion won)

	2008 Dec.15[2]	2009 Dec.14	2010 Dec.13	2011 Mar.14	2011 Jun.13	2011 Sep.5
Banks[1]	1,723	1,690	1,615	1,509	1,294	848
Insurance companies	259	45	34	25	23	0
Securities companies	87	59	46	45	28	18
Total	2,069	1,794	1,696	1,579	1,346	866

Notes: 1) Including Korea Finance Corporation.
2) Including 199.8 billion won of liquidity supplied by outright purchases of Treasury bonds and repurchases of MSBs prior to maturity.
Source: The Bank of Korea.

<Table II-7> **Supply of liquidity to counter the global financial crisis, and its withdrawal**

	Type	Scale	Withdrawal
Korean Won Liquidity (trillion won)	•Bank Recapitalization Fund	3.3 (0.5)[1]	Support still provided
	•Aggregate Credit Ceiling Loans	3.5 (1.0)[1]	Support still provided
	•Bond Market Stabilization Fund	2.1 (0.0)[1]	Entire amount withdrawn
	Sub-total	8.9 (1.5)[1]	-
	•Unscheduled ad hoc RP purchases	16.8	Entire amount withdrawn
	•Other Korean won liquidity[2]	2.3	One-off support
	Total	28.0	-
Foreign Currency Liquidity[3] (billion dollars)		26.8	Entire amount withdrawn

Notes: 1) Figures in parentheses are end-February 2012 basis.
2) Outright purchases of Treasury bonds, repurchases of MSBs prior to maturity, etc.
3) Foreign currency swaps, foreign currency loans, etc.
Source: The Bank of Korea.

Consequently, the outstanding balance of the liquidity supplied by the Bank to counter the global financial crisis but not yet collected was reduced as of end-February 2012 to 1.5 trillion won-consisting of 1.0 trillion won of the increase in the Aggregate Credit Ceiling Loans and 0.5 trillion won of the support for the Bank Recapitalization Fund.

Continued Efforts to Ensure Financial Stability

The Bank of Korea devoted a wide variety of efforts to minimizing the influence of destabilizing factors in financial and foreign exchange markets - such as the expanded volatility of capital in- and outflows, the spread of the sovereign debt problems in Europe, and the increased uncertainty regarding North Korea.

First, the Bank strove in concert with the government to enhance the effectiveness of macro-prudential policies related to the foreign exchange sector. It implemented supplementary measures including lowering the ceilings on foreign exchange banks' FX forward positions and restricting their investment in foreign currency-denominated bonds issued domestically for the purpose of Korean won financing. At the same time it adopted measures to facilitate the seamless implementation of the Macro-prudential Stability Levy. While constantly monitoring Korean won and foreign-currency liquidity conditions in the financial markets and the movements of price variables, it promptly put into operation emergency responses such as convening the 'Monetary and Financial Action Task Force'[12], when factors disruptive to the financial and foreign exchange markets occurred, including the downgrade of the US sovereign credit rating and the death of North Korean leader, Kim Jong Il. To enhance the Bank's capacity for responding to external shocks, moreover, the sizes of its swap arrangements with Japan and China were enlarged.

<Table II-8> **Operation of 'Monetary and Financial Action Task Force'**

Period	Background of operations	Times held
Aug.~Sep. 2011	The spread of the sovereign debt problems in Europe and the concerns over the US economic downturn	8
Dec. 2011	The possibility of geopolitical instability because of the death of North Korean leader, Kim Jong Il	4

Source : The Bank of Korea.

Furthermore it strove to forestall destabilization of the short-term funds market through, for example, a settlement failure by carefully monitoring banks' financing condition for reserve requirements and settlement funds such as at the time of the occurrence of a strike at SC First Bank that continued for more than five months from June 27, 2011, the longest-ever in Korea in banking history.

12) This is made up of the senior deputy governor of the Bank of Korea, the deputy governor in charge of monetary policy, and the heads of the related departments, six persons in all.

Enhancing the Macro-Prudential Soundness of the Foreign Exchange Sector

In order to moderate the volatility of capital in- and outflows, the Bank of Korea endeavored to put in place macro-prudential policies in the foreign exchange sector as scheduled. From the findings of its joint foreign-exchange examination with the Financial Supervisory Service of six banks during the months of April and May in 2011, it brought to light the problems of increasing overbought FX forward positions and the exploitation of foreign-currency denominated bonds issued domestically to circumvent measures to regulate foreign-currency loan use. Accordingly, through a process of cooperation with the Ministry of Strategy and Finance, Financial Services Commission, and Financial Supervisory Service, the Bank decided to lower the ceilings on foreign exchange banks' FX forward positions by 20%. In a further move, the Bank decided to revise its 'Detailed Working Rules on Foreign Exchange Transaction Business' to restrict foreign exchange agencies from investing in foreign currency-denominated bonds issued domestically for the purpose of Korean-won financing, starting from July 25, 2011.

<Table II-9> **Ceilings on FX forward positions**

	Introduced on Oct. 9, 2010	Lowering the ceilings on Jul. 1, 2011
Domestic banks	50%[1)]	40%[1)]
Local branches of foreign banks	250%[1)]	200%[1)]

Note: 1) The proportion to their capital as of the end of the previous months.
Sources: Ministry of Strategy and Finance, Financial Services Commission, The Bank of Korea, Financial Supervisory Service.

Meanwhile, in order to implement the 'Macro-prudential Stability Levy' from August 1, 2011, it realigned the relevant regulations by inter alia revising the

<Table II-10>**Major contents of Macro-prudential Stability Levy**

The obligator for payment	commercial banks, domestic branches of foreign banks, Industrial Bank of Korea, Korea Eximbank, The Korea Development Bank, Korea Finance Cooperation, Bank of National Agricultural Cooperative Federation, and National Federation of Fisheries Cooperatives
Bases of assessment	The outstanding amount of all non-deposit foreign currency liabilities(total foreign currency liabilities – foreign currency deposits)* *Daily average basis during the period
Rate	To be imposed according to debt maturity : 0.2% for less than 1 year, 0.1% for those between 1 and 3 years , 0.05% for 3 to 5 years, 0.02% for more than 5 years. Meanwhile, liabilities taken out by domestic regional banks from the financial institutions subject to the Levy to be charged with 50 percent less rates. (in case of an emergency, an extra levy can be imposed for up to 6 months to the total levy of up to 1.0%)
Accumulation and utilization of the Levy	To be imposed by the US dollar and accumulated to Foreign Exchange Stabilization Fund separately. The accumulated Levy will be used to support the financial institutions with foreign liquidity in case of an emergency.
Collection of the Levy	The notice of the Levy for liabilities will be issued in four months following the end of business year and liability should be paid in 5 months.

Sources: The Bank of Korea, Ministry of Strategy and Finance.

'Detailed Working Rules on Foreign Exchange Transaction Business' and establishing the 'Working Procedures for Business of the Macro-prudential Stability Levy'.

At the same time, through the construction of an information system and holding briefing sessions for financial institutions, it sought to ensure that the new system took root successfully. The levy, being imposed at differentiated rates according to maturity range on the outstanding amount of non-deposit foreign currency liabilities, has been devised in order to fully answer Korea's policy requirements while keeping in conformity with international thinking.

Enlargement of Scale of Currency Swaps with Japan and China

The Bank of Korea enlarged the scale of its currency swaps with Japan and China to guard against the possibility that the sovereign debt crisis in Europe could metastasize into a global systemic crisis.

In October it reached agreement with Japan on expanding the scale of the existing currency swaps from the equivalent of 13 billion dollars to a total amount equivalent to 70 billion dollars. The scale of its won/yen

<Table II-11> **Status of the Bank of Korea's currency swaps with foreign central banks[1]**

Type	Counterpart country	Swap currency	Scale	Announcement date	Remarks
Currency swap for liquidity support	US	National currency/ national currency	30 billion dollars	Oct. 2008	Expired in Feb. 2010
	China	〃	360 billion yuan (64 trillion won)[2]	Dec. 2008	An increase in the size[3] and an early renewal of the won-yuan swap arrangement in Oct. 2011
	Japan	〃	About 30 billion dollars	May 2005	Enlargement temporarily[4] in Oct. 2011
		US dollar/ national currency	30 billion dollars	Oct. 2011	Newly contracted
CMI (Chiang Mai Initiative) Multilateral	ASEAN+3 (including Hong Kong)	〃	120 billion dollars[5]	Dec. 2009 (valid from Mar. 2010)	Contributions of Korea are 19.2 billion dollars(16%) and it can be supported by 19.2 billion dollars, if needed.
CMI Bilateral	Japan	〃	10 billion dollars	Jul. 2001	Agreeing to be extended in Oct. 2011
	Malaysia	〃	1.5 billion dollars	Jul. 2002	-

Notes: 1) As of the end of 2011. 2) About 56 billion dollars.
3) 180 billion yuan (38 trillion won) → 360 billion yuan (64 trillion won). 4) About 3 billion dollars → about 30 billion dollars.
5) Contributions of each country: 38.4 billion dollars (32%) respectively by China and Japan, 24 billion dollars (20%) by ASEAN.
Source: The Bank of Korea.

currency swap with the Bank of Japan was increased from the equivalent of 3 billion dollars to the equivalent of 30 billion dollars. Also, in cooperation with the government, a currency swap was entered into with the Japanese Ministry of Finance on a US dollar/national currency swap on the scale of 30 billion dollars. It was also agreed that the existing 10 billion dollars bilateral currency swap under the Chang Mai Initiative (CMI) should be extended for a further period. In addition the Korean won/Chinese yuan currency swap with the People's Bank of China was enlarged from the previous 180 billion yuan (38 trillion won) to 360 billion yuan (64 trillion won). The enlargement of the scale of the currency swaps with Japan and China contributed not only to the stability of the Korean financial and foreign exchange markets by soothing concern about foreign currency liquidity shortages and acting to diversify borrowing lines but it is also evaluated[13] as having made a positive contribution to the outlook for the sovereign credit rating.

Heightening the Stability and Efficiency of the Payment and Settlement System

The Bank of Korea also devoted positive efforts to heightening the stability and efficiency of the payment and settlement system.

As a first step the Bank of Korea brought into operation a system for the supply of settlement liquidity using an intraday RP system in regard to financial investment companies and Korea Exchange (KRX) from February 20, 2012, in order to give its support to improvement of the settlement system of the KRX Electronic Trading System for government bonds to encourage the bringing-forward of the settlement of interbank funds processed through BOK-Wire+. The intraday support ceiling is limited to the relevant amount within 25% of the equity capital of the institutions eligible for intraday RP transactions, but no specific upper limit is set on the KRX itself to ensure that sufficient support is available for its funding demands acting as a central counter-party[14].

In addition the Bank of Korea prepared a facility for absorbing intraday liquidity supplied during the same day in order to avoid this exercising an influence on the routine conduct of monetary policy. It is

13) On November 7, 2011, Fitch, an international credit rating agency, upwardly adjusted the outlook for the Korean sovereign credit rating (A+) from stable to positive, partly on the grounds of the enlarged scale of the currency swaps with Japan and China.

14) A central counter-party carries out the role of a buyer in regard to the seller for an agreement entered into in the securities market and the role of a seller in regard to a buyer.

anticipated that the implementation of this scheme will lighten the financial investment companies' burden to source funds for bond settlement and it will reduce settlement risk.

Meanwhile, in order to implement the recommendations[15] of the related international agency and reduce the settlement risk of security transactions, the Bank of Korea, in cooperation with KRX and the Korea Securities Depository, changed the settlement bank for funds of share transactions on exchange from two commercial banks (Shinhan and Woori) to the Bank of Korea itself. Previous to this, in the event of the failure of the settlement bank there was the possibility of systemic risk spreading in that not only KRX would have been exposed to settlement risk and liquidity risk but also the institutions receiving funds of payment likewise would have experienced settlement risk of difficulties in or delays on collecting the settlement proceeds. By changing the settlement bank for share transaction funds from commercial banks to the Bank of Korea, a foundation was put in place whereby this problem could be resolved to a considerable degree.

Carrying out Joint Examinations and Requests for Examination

From July 2011 to February 2012, the Bank of Korea carried out jointly with the FSS general examinations of four banks and two financial investment companies. Besides this, in September 2011 it requested the FSS to undertake the examination of one bank.

<Table II-12> **Joint examinations with the FSS[1]**

(times, number)

			2008	2009	2010	2011	2012. Jan.~ Feb.
Joint examination	General examinations	Banks	3	5	7	7	-
		Financial investment corporations	-	-	1	4	-
	Partial examinations	Banks	2 (10)	1 (7)	1 (5)	2 (2)	-
		Financial investment corporations	-	-	-	-	-
Examination requests		Banks	1	2	1	1	-
		Financial investment corporations	-	-	-	-	-

Note: 1) Figures in parentheses are numbers of institutions that under went partial examinations.
Source: The Bank of Korea.

15) BIS CPSS-IOSCO advised in its 'Recommendations for Securities Settlement Systems' that the settlement of securities transaction payments utilize the funds of the central bank, which are free of credit and liquidity risk.

III

Global and Domestic Economic Conditions and Future Monetary Policy Direction

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1. Global Economy

A. Economic Growth

Over the course of 2012 major economic forecasting organizations anticipate that the world economy will show a mild trend of recovery. There do remain uncertainties as to the economic growth path, however, influenced by risk factors such as the sovereign debt problems in Europe and the geopolitical risks in the Middle East. In terms of the risks to growth, the downside risks are seen to be the greater in that the uncertainty as to the evolution of the sovereign debt problems in Europe remains as great as ever while there is also the possibility of geopolitical instability because of the Iranian nuclear issue.

<Table III-1> **Outlook for world economic growth**[1]

(%)

	2011[1]	2012[e]		2013[e]	
		IMF	World Bank	IMF	World Bank
World	3.8	3.3	3.4	3.9	4.0
(US)	1.7	1.8	2.2	2.2	2.4
(Japan)	-0.7	1.7	1.9	1.6	1.6
(Euro area)	1.4	-0.5	-0.3	0.8	1.1
(China)	9.2	8.2	8.4	8.8	8.3

Note: 1) Based on IMF statistics for world; based on their own statistics for individual countries and the euro area.
Sources: IMF, World Economic Outlook Update, Jan. 2012; World Bank, Global Economic Prospects, Jan. 2012.

The US economy is predicted to maintain its economic recovery led by personal consumption and firms' facilities investment. As the US Federal Reserve's zero interest rate policy is to be maintained, consumption which shrank for some time is set to increase and firms that are flush with cash and equivalent assets are forecast to continually expand their facilities investment. Nevertheless the pace of recovery is expected to be only moderate as the continued deleveraging by households and reductions in government fiscal expenditure are expected to limit the degree of improvement in the labor and housing markets. Moreover ahead of the presidential and Congressional elections in November 2012, there is the likelihood of economic recovery momentum weakening should interparty strife intensify in regard to proposals for the reduction of the budget deficit.

In the euro area economy, a mild recession is forecast to emerge since drawing up a fundamental solution of the sovereign debt problems is expected to take a considerable length of time; the sapping of economic confidence, financial institutions' efforts to improve asset soundness, which reduce their scope for lending, and the intensification of fiscal tightening will lead to subdued private consumption, facilities investment, and government expenditure. It is foreseen in particular that the economic downturn will become more severe in Greece, Portugal, Italy and Spain, which are experiencing difficulties because of sovereign debt problems, and that the German and French economies will see listless growth.

The Japanese economy is forecast to show a mild recovery trend as the supply of components, which was hit by setbacks because of the massive flooding in Thailand, is expected to return to normal and as reconstruction following the massive Japanese earthquake will be pursued continually. An acceleration of the recovery trend is expected to be held back, however, as no great improvement in export conditions is likely in view of the slowing of global demand.

The Chinese economy's pace of growth is expected to show a moderate weakening. The scale of the expansion of exports to the euro area will narrow and the increasing trend of domestic demand will also weaken under the effects of the monetary tightening measures undertaken for some time and the steps taken to rein in speculation. Consumption, nonetheless, should show robust growth against the backdrop of rising wages, the continued large-scale investment in farming areas, the construction of public housing for low-income households, and the maneuvering room open to monetary and fiscal policy. In view of these considerations, there is seen to be little likelihood of the rate of growth falling steeply.

The growth of other emerging economies is predicted to exhibit similar trends. The Brazilian economy is forecast to continue a moderate growth trend as the effects of an expansion of SOC investment will be offset by the contraction of the increase in exports due to the blunting of the global recovery trend. In the Indian economy, even though the increase in domestic demand is anticipated to be consolidated, helped by rising incomes, economic growth is seen to slow because of the effects of the monetary policy tightening measures undertaken for some time and the deterioration of the current account amid worsening external conditions.

B. Prices

In 2012 the upward trend of global prices is forecast to slacken by and large in line with the weakening of the world economy's recovery trend. There is, however, the possibility that the geopolitical risk in the

Middle-East in relation to the Iranian nuclear issue and abnormal weather conditions will act as major upside risks on the cost side.

<Table III-2> **Outlook for CPI**

(%)

	2011[1)]	2012[e]		2013[e]	
		IMF	OECD	IMF	OECD
Advanced economies	2.7	1.6	-	1.3	-
(US)	3.2	-	2.4	-	1.4
(Japan)	-0.7	-	-0.6	-	-0.3
(Euro area)[2)]	2.8	-	1.6	-	1.2
Emerging and developing economies	7.2	6.2	-	5.5	-

Notes: 1) Based on IMF statistics; based on their own statistics for individual countries and the euro area.
2) Outlooks in 2012~13 are based on 15 countries in OECD.
Sources: IMF, World Economic Outlook Update, Jan. 2012;
OECD, Economic Outlook, Nov. 2011.

As US economic growth is still failing to reach the potential growth rate, the pace of inflation is expected to slow. Similarly, in the euro area, the rate of inflation is seen to fall in view of the moderation of demand-side pressures because of slack private sector demand and government spending cuts. In the case of Japan, deflation is seen to continue as the supply and demand imbalances throughout the economy as a whole persist.

In China and other emerging countries the trend of price increases is expected to moderate as cost-side factors including stabilization of food prices and the reduction of demand-side pressures in line with the slowdown of growth trends act in combination.

C. Exchange Rates and International Commodity Prices

In the international financial markets, the preponderance of opinion is that the US dollar will show a firm trend against the euro but a weakening trend against the Japanese yen amid worries over the persistent uncertainty as to the evolution of the sovereign debt problems in Europe and expectations of the ECB's lowering of its policy rate and expansion of the supply of long-term liquidity. The possibility, however, cannot be excluded that the greenback will lose ground against the euro and strengthen against the Japanese yen if plans put forward for the resolution of the sovereign debt problem gain market credibility within the euro area and if the possibilities of a downgrade of Japan's sovereign credit rating and the continuation of its trade deficit are actually realized.

International oil prices are expected to fluctuate generally around their recent level. Although the increased demand for crude oil will be checked by the slowdown in economic activity, there are factors present that will act to harden up the price rigidity of oil prices including the expansion of demand arising from the drawing-down of stockpiles, the constraints on increased extraction of crude oil, and the Iranian nuclear issue.

<Table III-3> Outlook for oil prices[1]

(US$/barrel)

		2011	2012e					2013e
			Year	Q1	Q2	Q3	Q4	
<Brent>		111.0						
CERA	(Feb. 28)		115.1	111.2	114.0	117.0	118.3	117.5
CGES	(Jan. 23)		107.0	110.8	109.8	105.8	101.7	
OEF	(Feb. 27)		111.9	117.2	118.0	108.0	104.6	104.9
Barclays Capital	(Feb. 24)		115.0	110.0	118.0	112.0	121.0	
<Dubai>		106.2						
CERA	(Feb. 28)		112.0	109.0	110.1	112.6	115.4	114.0

Note: 1) Period-average; figures in parentheses refer to the date of the forecast.
Sources: CERA, CGES, OEF.

Other international commodity prices are forecast to be downwardly stable. Grain prices are expected to follow a downward trend as supplies increase thanks to improved weather conditions, in addition to which they will be hard put to sustain their high price level. In particular the increased production by Russia and some other countries that had limited grain exports following droughts and forest fires in 2010 is likely to contribute substantially to increasing world grain supply in 2012. Prices of nonferrous metals are expected to shift to a downward track as the trend of growing demand for them slows again upon the cessation of China's build-up of nonferrous metal stockpiles that began in the latter half of 2011.

2. Domestic Economy

A. Real Economy

During the year 2012, domestic economic activity is forecast to continue to show signs of slackening throughout most of the first half of 2012, being unable to attain its long-term growth trend, but to present an upward albeit modest trend in the second half as uncertainties lessen. However the downside risk factors to domestic economic growth are expected to remain heightened for some time, influenced by external risk factors.

<Table III-4> **Outlook for economic growth**[1)]

(%)

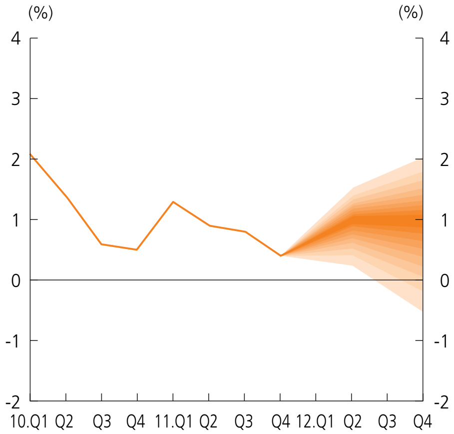
	2011			2012[2)]			2013[2)]
	Year	1st half	2nd half	Year	1st half	2nd half	
Real GDP	3.6	3.8	3.5	3.7	3.4	3.8	4.2
Private consumption	2.2	2.9	1.6	3.2	2.6	3.6	4.0
Facilities investment	3.8	9.4	-1.2	4.2	0.3	7.9	7.0
Construction investment	-6.5	-9.0	-4.3	2.8	4.4	1.4	2.4
Exports	11.1	14.9	7.7	5.0	3.5	6.4	10.2
Imports	8.8	11.8	6.1	5.2	2.5	7.7	10.4

Notes: 1) Compared with the same periods of the previous years.
2) The figures are forecast in December 2011.
Source: The Bank of Korea.

Private consumption is expected to expand the scale of increase in view of the enhanced real purchasing power of households thanks to the improvement in the terms of trade and slowing pace of rising prices, but its increase is forecast to still fall short of its level before the financial crisis (average annual rate of 4.1%, 2001-2007) because of structural weakness such as the cumulative increase of household debt.

The scale of the increase in facilities investment is forecast to be constrained by the continued uncertainty as to global economic conditions. Construction investment is forecast to pick up, led by the construction of buildings as that of those for residential use shows stirrings of improvement, above all in provincial areas, while that of those for non-residential use will regain its upward trend owing to the relocation of government and public agencies.

<Figure III-1> **Economic growth fan chart**[1)]



Note: 1) Compared with the previous quarters; future forecast as of December 2011.
Source: The Bank of Korea.

Exports (volume basis) are foreseen to rise on a considerably narrower scale due to the weakening of the trend of global economic growth in line with the sovereign debt problems in Europe and to the base effect from the large increase last year. Imports (volume basis) are also expected to slacken their upward trend influenced by the weakening of exports.

The current account will, it is foreseen, register a greatly narrowed surplus owing to a large-scale reduction in the goods account surplus together with a slight widening of the deficit on services account.

Labor market conditions will maintain their trend of improvement, but the scale of the increase in employment is forecast to be only limited because of the slowing of manufacturing growth and the weakening labor absorption capacity of service businesses.

B. Prices

In the course of 2012 consumer price inflation is forecast to retreat to a little above the 3% level, as demand side pressures ease, but inflation expectations are expected to continue running at a high level for some time. The rate of core inflation, which shows the underlying trend of prices, is forecast to exhibit a level similar to or a little higher than that of last year. Meanwhile, the potential exists for developments such as a rise in international oil prices due to the economic sanctions against Iran and abnormal weather

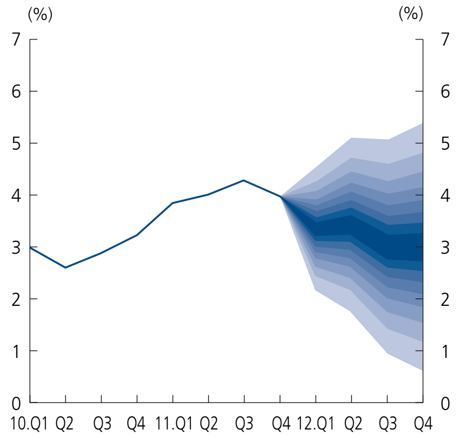
<Table III-5> **Outlook for inflation**[1)]

(%)

		2011			2012[2)]			2013[2)]
		Year	1st half	2nd half	Year	1st half	2nd half	Year
Consumer price		4.0	3.9	4.1	3.3	3.5	3.1	3.2
Core inflation	CPI excluding agricultural products & oils	3.2	2.9	3.4	3.3	3.2	3.5	3.2
	CPI excluding food & energy	2.6	2.4	2.7	2.7	2.7	2.8	2.5

Notes: 1) Compared with the same periods of the previous years.
2) The figures are forecast in December 2011.
Sources: The Bank of Korea, Statistics Korea.

<Figure III-2> **Consumer price inflation fan chart**[1)]



Note: 1) Compared with the same periods of the previous years; future forecast as of December 2011.
Source: The Bank of Korea.

conditions acting on the supply side factors causing price instability.

C. Financial Markets

In the financial markets, there is the likelihood that price variables and in- and outflows of foreign portfolio investment funds will exhibit a high degree of volatility, in line with the evolutions of external destabilizing factors.

3. Future Monetary Policy Direction

The Bank of Korea will conduct its monetary policy so as to stabilize consumer price inflation at the midpoint of the inflation target over a medium-term horizon, amid continuing sound growth of the domestic economy. To this end the Bank will closely monitor both the downside risks to the growth path posed by financial and economic risk factors at home and abroad, and the progress of the climate of high inflation expectations. It will reflect these factors in its policy implementation.

The Bank will strive further to enhance its monetary policy effectiveness. Policy efforts will be directed toward ensuring that the measures modified or introduced by the revision of the Bank of Korea Act (September 16, 2011) - such as the imposition of reserve requirements on some types of financial bonds, the method of managing required reserves on a monthly basis, and securities lending facility - take firm root at an early stage. To heighten the transparency and predictability of monetary policy, the Bank will also continue to strive to strengthen its policy communications. The Bank plans in addition to work to ensure the seamless supply of financial institution funds to SMEs and other fragile sectors, by way for example of improvements in its Aggregate Credit Ceiling Loans.

This is the final year of the current medium-term inflation target period (2010-2012), and the inflation target for 2013 and onward will be decided in consultation with the government.

The Bank plans to devote positive efforts toward financial stability, including by strengthening its drive to identify and address financial sector fragilities and systemic risks. The stage-by-stage comprehensive contingency plan in preparation against deterioration in financial and foreign exchange market conditions, due for example to an abrupt surge in outflows of foreign funds or to elevated geopolitical risks, will be continually reexamined and supplemented. The efforts to ensure a soft landing of the household debt problem will be continued as well, in cooperation with the government and other related organizations. The Bank will redouble its efforts to promote cooperation with major central banks and international financial institutions.

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