March 2009

Monetary Policy Report

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THE BANK OF KOREA

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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.

Seongtae Lee

Lee, Seongtae

Governor
the Bank of Korea

Monetary Policy Committee

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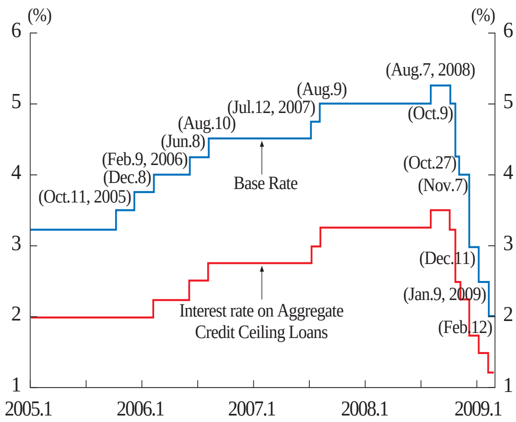
Executive Summary

1 In the wake of Lehman Brothers' filing for bankruptcy protection in September 2008, the Bank of Korea conducted monetary policy with foremost priority on minimizing the negative effects on the domestic financial markets and real economy arising from the worsening overseas environment in the forms of global financial market turmoil and economic recession.

Bank of Korea Base Rate[1] and interest rate on Aggregate Credit Ceiling Loans



Note: 1) Overnight call rate target until February 2008.
Source: The Bank of Korea.

2 The Bank of Korea, in line with this policy stance, brought its Base Rate down substantially from 5.25% to 2.0%, in six steps between last October and February this year. It also lowered the interest rate on its Aggregate Credit Ceiling Loans from 3.5% to 1.25%.

Together with this, the Bank strove actively to ease the credit crunch through its open market operations, lending facilities and reserve requirements.

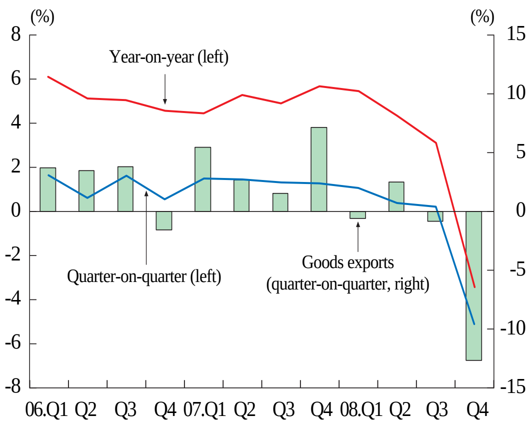
In order to encourage flows of funds into the risk-bearing debt securities market, the Bank included bank debentures and certain government agency bonds among the securities eligible for its open market operations, while also greatly expanding the number of its securities company counterparts for RP transactions. Meanwhile, it also provided liquidity support to financial institutions subscribing to the Bond Market Stabilization Fund.

In addition, the Bank raised its Aggregate Credit Ceiling by 2.5 trillion won in November, from 6.5 trillion won to 9.0 trillion won, to boost the incentives for bank lending to SMEs. In December, to help banks expand their credit supply capacity by raising their BIS capital adequacy ratios, it paid interest of 500.2 billion won on banks' required reserve deposits.

The Bank also redoubled its efforts to stabilize the foreign exchange markets. Foreign currency liquidity was supplied to financial institutions through swap transactions as well as loans using the proceeds of a currency swap with the US Federal Reserve. Foreign currency availability was also expanded by establishing swap agreements with the Bank of Japan and the People's Bank of China in addition to that with the Federal Reserve.

As the Bank of Korea embarked actively on financial easing, the year-on-year rate of reserve money growth (on a period average basis) rose sharply from the 8.7% of last August to 27.4% this January. The net redemption of Monetary Stabilization Bonds (MSBs) occurring in this process caused the outstanding volume of MSBs to shrink, from 138.0 trillion won at the end of August to 135.8 trillion won as of the end of February.

GDP growth rate

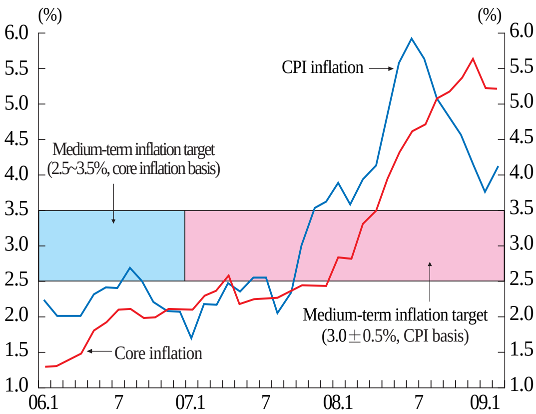


Source: The Bank of Korea.

3 Looking at the movements of the real economy as the background to these policy decisions, domestic economic activities declined rapidly from the fourth quarter of last year, with domestic demand in terms of consumption and investment shrinking still further and exports falling sharply.

Quarter-on-quarter GDP growth tumbled to -5.1% (-3.4% year-on-year) in the fourth quarter from 0.2% (3.1% year-on-year) in the third quarter. Continuing on into this year, domestic economic activities have kept on contracting in line with the deepening synchronized downturn in both developed and emerging market economies.

CPI and core inflation[1]



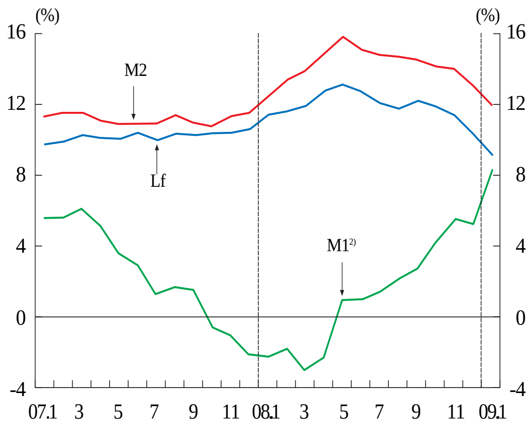
Note: 1) Compared with the same period of the previous year.
Source: Korea National Statistical Office.

4 The upward trend of prices softened markedly from the second half of last year, as the effects of business activity weakness were added to the drop in oil and other commodity prices. Consumer price inflation, which had reached a peak of 5.9% year-on-year last July, fell to register 4.1% this February. Core inflation climbed to 5.6% year-on-year last December, but has declined from the beginning of this year and stood at 5.2% in February.

House prices continued to fall from last October onwards, as demand weakened greatly amid the downturn in economic activity. Land prices, similarly, shifted to a declining trend from November.

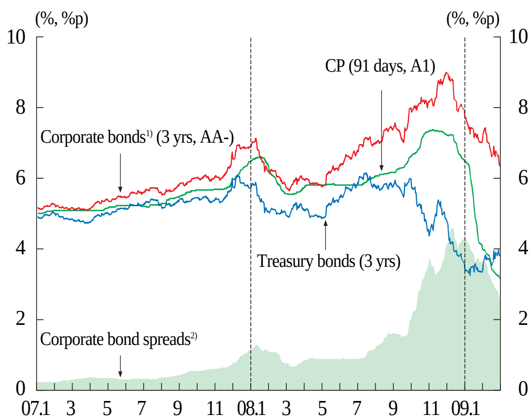
5 In the financial markets, the scale of increase in SME lending contracted markedly and the upward trend of household lending slowed from the latter half of last year, owing to banks' conservative fund operation in

Growth rates[1] of Lf, M2 and M1



Notes: 1) Compared with the same period of the previous year. Based on the monthly averages.
2) Excludes MMFs.
Source: The Bank of Korea.

Market interest rates



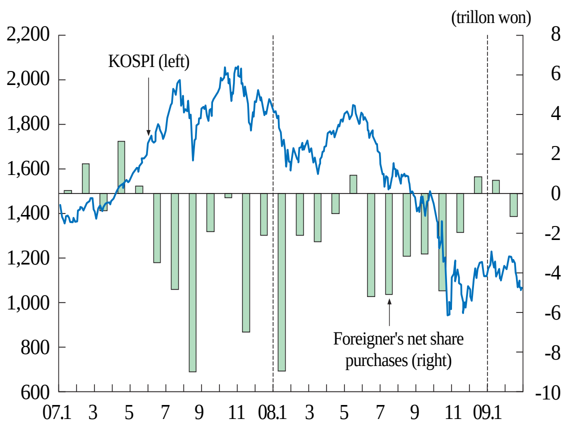
Notes: 1) Based on the averages of yields estimated by three private credit rating corporations.
2) Corporate bond (3 yrs, AA-) yields - Treasury bond (3 yrs) yields.
Source: Koscom Corp.

response to worries about credit risk. As a result, the growth rates of M2 and Lf fell by considerable margins. In contrast, the growth rate of narrow money M1 rose greatly reflecting the Bank of Korea's active policy steps for financial easing.

Market yields on Treasury bonds and risk-bearing debt securities exhibited different patterns. While Treasury bond yields showed a downward trend from October of last year influenced by the reduction in the Base Rate, yields on corporate bonds and CP rose steeply owing to the heightened credit risk until mid-December, when they shifted to a declining trend in response to the efforts by the government and the Bank of Korea to stabilize the financial markets. Meanwhile, the spreads of three-year corporate bond (AA-) yields over Treasury bond yields widened greatly, from 1.62 percentage points at the end of last August to 2.55 percentage points as of the end of February.

Bank deposit and lending rates shifted to downward trends from last November onwards, reflecting the movements of market interest rates on CDs and bank debentures.

KOSPI and foreigner's net share purchases

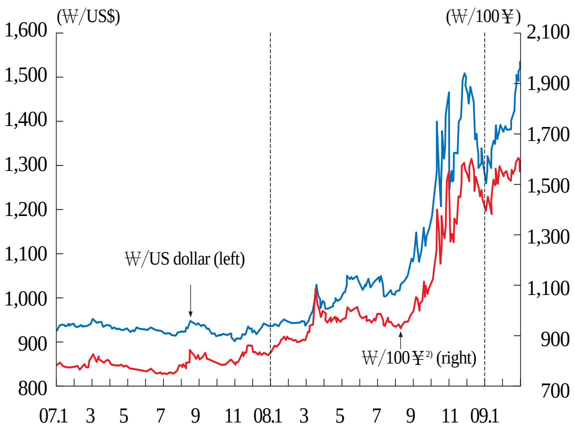


Source: Koscom Corp.

Share prices retreated on a large-scale in response to the synchronized fall in global share prices and net selling of domestic shares by foreigners in the wake of the heightened global financial market turmoil. This brought the KOSPI down to 939 in late October. The KOSPI subsequently broke from this downward trend to fluctuate in the 1,000 to 1,200 range, helped by the endeavors of Korea and other major countries to stabilize the financial markets and bring about an economic activity recovery. It registered 1,063 at the end of this February. Meanwhile, the foreign share of total Korean stock market capitalization declined from 28.9% at the end of last August to 26.6% as of the end of February.

6 In its operation of monetary policy, the Bank of Korea also paid close attention to both the government’s fiscal policy stance and exchange rate movements. In response to the economic downturn, the government operated an expansionary fiscal policy, as a result of which the consolidated fiscal account balance showed a large deficit for the second half of last year.

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. and Korean Exchange Bank.

The Korean won/US dollar exchange rate rose steeply from mid-September last year, owing to the outflow of foreign portfolio funds and the worsening of foreign currency borrowing conditions amid the global financial market turmoil. This brought the Korean won to 1,513 won per US dollar in late November. In December, the rate fell back to the 1,200 won level in response to foreign investors' net buying of stocks, to the surplus in the current account, and to the endeavors of the government and the Bank of Korea to stabilize the foreign currency markets. From the beginning of 2009, however, on concerns about a deterioration of foreign currency supply and demand conditions following the increase in credit risk in Eastern European countries, the exchange rate climbed steeply again to 1,534 won per dollar as of the end of February.

7 Looking at the future environment for monetary policy operations, the Korean economy is forecast to register negative GDP growth in 2009, in line with the very weak domestic demand and continuing downward trend of exports due to the global economic recession. The current account is expected to

show a surplus for the year as a whole as imports shrink on a much larger scale than exports.

The upward trend of prices is expected to be blunted by the downward stability of international commodity prices and wages and by the weakening of demand pressures owing to the recession.

In the financial markets, the supply of credit is likely to be restricted by the continued global financial market turmoil, the contraction of economic activity and the uncertainties surrounding corporate restructuring. There is also the constant possibility of episodes of heightened volatility in price variables such as share prices and exchange rates.

8 As prices are expected to maintain their stability, the Bank of Korea will conduct monetary policy with a main emphasis on supporting the recovery of economic activity and improving financial market conditions.

The Bank plans to operate the Base Rate in such a way as to maximize its policy effectiveness while keeping a close watch on conditions in the real economy and financial markets.

The Bank will concentrate its policy capacities on bringing about the orderly working of financial intermediation. It will seek to induce flows of funds to sectors suffering from credit supply constraints, through positive application of its open market operations and Aggregate Credit Ceiling Loans. At the same time, it will try to improve credit supply conditions by, for example, providing effective support for banks' efforts to expand their capital. In the event of a further deterioration of financial intermediation, it will prepare proposals for more active supply of liquidity.

Together with this, the Bank intends to prepare a market-friendly exit policy for when financial market conditions are much improved, to phase out use of the wide range of policy instruments introduced in response to the current financial unrest.

In addition, as this is the last year of the three-year inflation target period that started from

2007, the Bank will set a new inflation target this year to take effect from 2010, and review the way in which it will be operated.

Ⅰ. Economic and Financial Developments

1. Global Economy

A. Economic Growth

During the second half of 2008, the recessions in advanced economies deepened and the growth trends of emerging economies declined steeply, as the global financial market turmoil brought about a full-fledged contraction of real economic activity.

The US economy contracted further as the influence of the decline in housing activity was reinforced by a credit crunch. In the third quarter, while residential investment continued to shrink, personal consumption expenditures and business investment also shifted to declines, causing GDP growth to register an annualized -0.5%. In the fourth quarter, as the sluggishness of domestic economic activity intensified still further, GDP fell sharply at an annual rate of 6.2%. For the year of 2008 as a whole, GDP increased just 1.1%, a marked deceleration compared with the 2.0% growth in the previous year.

The Japanese economy, just like the US economy, also contracted further. GDP fell at an annual rate of 1.4% in the third quarter owing to decreases in private consumption and facilities investment. In the fourth quarter, as the fall in facilities investment deepened and exports contracted rapidly, GDP dropped further at an annual rate of 12.1%. GDP growth for the year overall also turned negative, at -0.6% after 2.4% in the previous year.

Table Ⅰ-1

Economic growth of major economies[1]

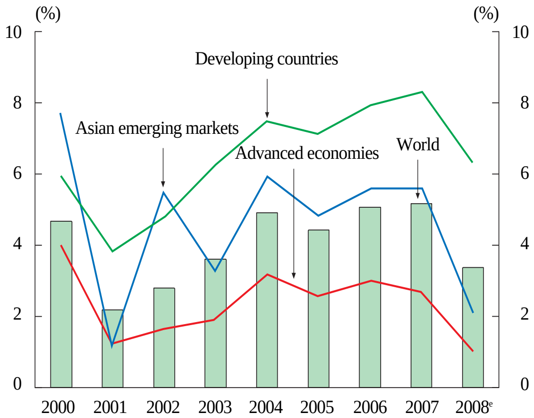
(%)

	2006	2007	2008[2] Year[e]	Q1	Q2	Q3	Q4
World	5.1	5.2	3.2[4]	-	-	-	-
Advanced economies	3.0	2.7	0.8[4]	-	-	-	-
US	2.8	2.0	1.1	0.9	2.8	-0.5	-6.2
Japan	2.0	2.4	-0.6	1.4	-4.5	-1.4	-12.1
Euro area	2.9	2.6	0.8	2.8	-1.0	-1.0	-5.7
Asian emerging markets[3]	5.6	5.6	2.1	-	-	-	-
Developing countries	7.9	8.3	6.1[4]	-	-	-	-
Asia	9.9	10.6	7.8	-	-	-	-
(China)	11.6	13.0	9.0	10.6	10.1	9.0	6.8
Latin America	5.5	5.7	4.6	-	-	-	-

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 US, Japan, and the euro area are annualized percentage changes from the preceding quarter, and Chinese figures are compared with the same period of the previous year.
3) Korea, Taiwan, Hong Kong and Singapore.
4) Based on IMF statistics, March 2009.
Sources: IMF, World Economic Outlook, October 2008 and January 2009.
Global Economic Policies and Prospects, March 2009.

Figure Ⅰ-1

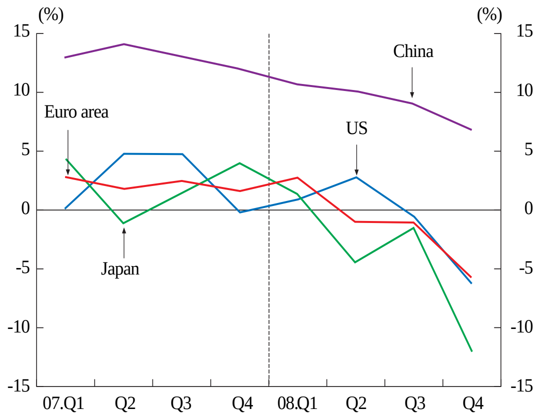
World economic growth[1]



Note: 1) Based on IMF statistics, the figures of 2008 are based on the publication of March 2009 (Asian emerging markets' figures are based on the publication of January 2009).
Sources: IMF, World Economic Outlook, January 2009.
Global Economic Policies and Prospects, March 2009.

Figure Ⅰ- 2

Economic growth[1] of major economies



Note: 1) The figures of the US, Japan, and the euro area are annualized percentage changes from the preceding quarter, and Chinese figures are compared with the same period of the previous year.
Sources: Individual countries' published statistics.

The euro area economic downturn gathered pace as well. GDP dropped at an annual rate of 1.0% in the third quarter and 5.7% in the fourth quarter. Growth for the year as a whole stood at just 0.8%, well below the 2.6% of the previous year.

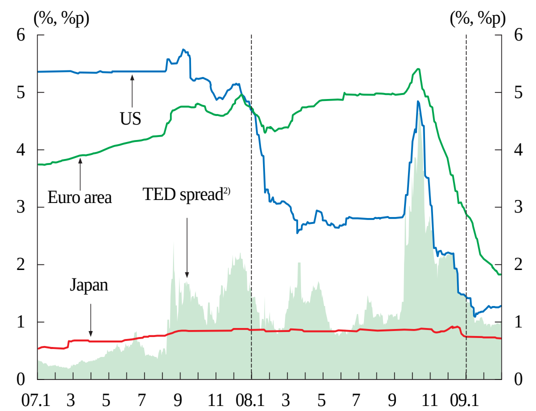
The Chinese economy showed a marked weakening of growth momentum. After falling to 9.0% in the third quarter, year-on-year GDP growth declined even further to 6.8% in the fourth quarter, as domestic demand decelerated and exports fell sharply. Annual growth registered 9.0%, down by a considerable margin from the previous year's 13.0%.

B. International Financial Markets

In the global financial markets, as the impact of the Lehman Brothers bankruptcy protection filing in September strengthened the trend of aversion to credit risk, the volatility of price variables greatly increased in terms of interest rates, exchange rates and stock prices.

Figure Ⅰ- 3

Short-term interest rates in major economies[1]



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

Short-term market interest rates in major countries rose sharply from the middle of September, but then shifted to a steep downward trend as central banks lowered their policy rates substantially to stabilize the financial market.

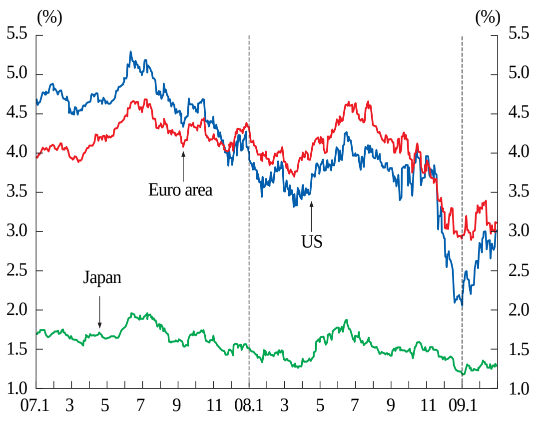
After Lehman Brothers filed for bankruptcy protection, US short-term interest rates (three-month LIBOR) rose rapidly to 4.82% on October 10. They subsequently fell back steeply, to stand at 1.26% as of the end of this February, as the Federal Reserve brought its policy rate down to near zero (0 ~ 0.25%) and increased its provision of liquidity. The TED spread (three-month

LIBOR minus the T-Bill rate), which is an indicator of credit risk in the short-term financial markets, also widened rapidly and then narrowed considerably in combination with short-term rates.

Euro area short-term interest rates (three-month EURIBOR), after peaking at 5.39% on October 9, shifted to a downward trend registering 1.83% at the end of this February. Japanese short-term interest rates (three-month TIBOR) were not particularly volatile. They then fell slightly from November onwards following reduction of the policy rate, closing February at 0.71%.

Figure Ⅰ- 4

Long-term interest rates in major economies[1)]



Note: 1) Based on each country's 10-year Treasury bond yields, apart from the euro area which is based on the 10-year German government bond yields.
Source: Bloomberg.

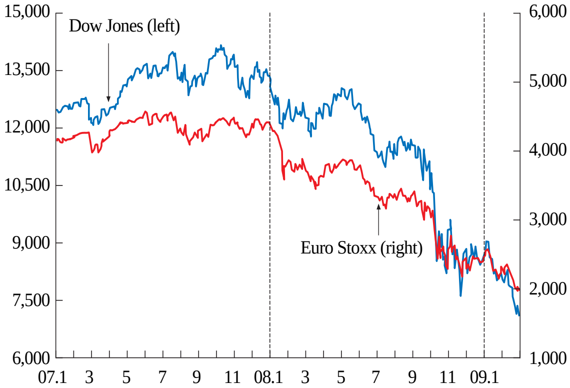
Long-term market interest rates (10-year Treasury bond yields) in major countries dropped sharply in line with the declines in economic activities.

US long-term interest rates fluctuated within a narrow range from mid-September, but from November onwards fell steeply amid heightened worries about a recession and deflation, dropping to 2.05% as of December 30. From the beginning of this year, they rose considerably to stand at 3.01% as of the end of February, on expectations of increased issuance of Treasury bonds to cover the widening fiscal deficit.

Euro area long-term interest rates showed a pattern of movements similar to those in the US, dropping to 2.89% as of January 15 this year and then rebounding to register 3.11% at the end of February. Japanese long-term interest rates, after falling to 1.17% at the end of December, rose slightly to stand at 1.28% as of end-February this year.

Figure Ⅰ- 5

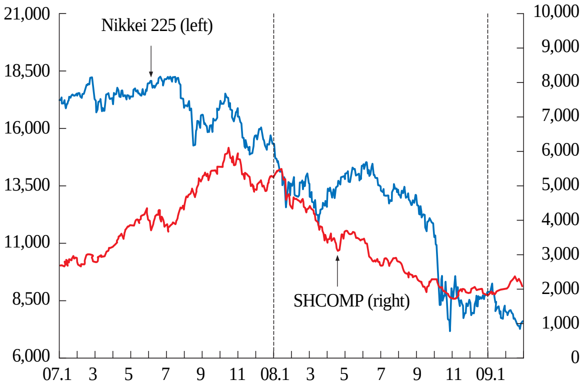
US and euro area stock price indices[1]



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

Figure Ⅰ- 6

Japan and China stock price indices[1]



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

Stock prices in major countries continued their weakening trend.

In the US, the Dow Jones Industrial Average fell sharply from mid-September to register 7,552.3 on November 20. Subsequently, helped by the aggressive economic and financial market stabilization policies of the US government and the Federal Reserve, this sharp downward trend slowed and the Dow rebounded to 8,776.4 as of the end of December. From the beginning of this year, it then returned to a downward trend, due to the deepening economic recession and the expanded losses of financial institutions. As of the end of February it fell by 38.8% from its level at the end of last August, standing at 7,062.9.

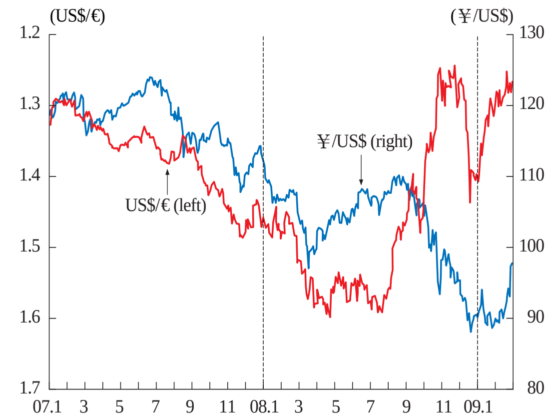
Stock prices in the euro area and Japan also fell by large margins from mid-September last year. As of the end of this February the Euro Stoxx stood at 1,976.2 and the Nikkei 225 at 7,568.4, declines of 41.3% and 42.1%, respectively, compared with the end of last August. In China, although showing underlying weak trends, stock prices fell to a relatively limited extent compared with those in advanced countries. As of the end of February, the Shanghai Composite Index fell by 13.1% from its level at the end of last August to stand at 2,082.9.

The US dollar showed a strengthening trend against the euro but a weakening trend against the Japanese yen.

Against the euro, the dollar maintained its strength in line with the flight-to-safety phenomenon, and it traded at 1.25 per euro as of November 20. In December the dollar exhibited a weakening trend for some time in response to the Federal Reserve's implementation of a

Figure Ⅰ- 7

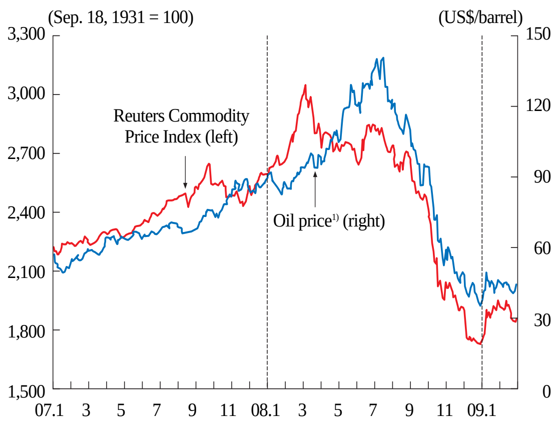
Major exchange rates[1]



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

Figure Ⅰ- 8

Oil and other commodity prices



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

zero interest rate policy, but it subsequently shifted back to a renewed strengthening trend that brought it to 1.27 per euro as of end-February, a 15.9% appreciation since the end of last August.

Against the Japanese yen, meanwhile, the dollar maintained a weakening trend amid unwinding of the yen carry trade from September, before shifting to a strengthening trend from mid-December owing to the deepening economic recession in Japan. As of the end of February, a dollar traded for 97.7 yen, a depreciation of 10.4% compared with last end-August.

C. International Commodity Prices

International oil prices dropped sharply from last July. After soaring to all-time high 141.3 dollars per barrel (Dubai crude basis) on July 15, the price of oil shifted to a steeply downward trend that brought it to 34.7 dollars per barrel as of December 26, by reduced demand following the slowdown of global economic activity and by outflows of speculative capital from the international commodity markets. From the beginning of this year, the price of oil fluctuated at around the level of 40 dollars per barrel, and as of the end of February it traded at 44.5 dollars per barrel, 67.4% lower than at the end of June last year.

The prices of international non-oil commodities (on the basis of the Reuters Commodity Price Index) also declined sharply. Those of grains such as wheat and corn fell by large margins, thanks to improved harvests following the more favorable weather conditions and to the softening of demand for biofuel use in line with the drop in oil prices. Prices of nonferrous metals such as copper and aluminum also fell sharply influenced by the global economic recession. As of the end of February, the Reuters Commodity Price Index stood at 1,844.8, 35.2% lower than at the end of June last year.

2. Domestic Economy

A. Economic Growth

Domestic economic activities declined rapidly from the fourth quarter of last year, with domestic demand in terms of consumption and investment shrinking still further and exports falling sharply. Viewing the performance by quarter, quarter-on-quarter GDP growth tumbled to -5.1% (-3.4% year-on-year) in the fourth quarter from 0.2% (3.1% year-on-year) in the third quarter.

Real gross national income (GNI) growth exhibited -3.6% in the third quarter. It then registered -1.6% in the fourth quarter, however, to stand above the GDP growth rate, owing to the improvement in the terms of trade thanks to the fall in the international oil price.

Table Ⅰ-2

Major economic growth indicators[1]

(%)

	2006	2007	2008p Year	2008p Q1	2008p Q2	2008p Q3	2008p Q4
GDP	5.2	5.1	2.2	1.1 (5.5)	0.4 (4.3)	0.2 (3.1)	-5.1 (-3.4)
(Private consumption)	4.7	5.1	0.9	1.1 (4.0)	-0.2 (2.3)	0.0 (1.4)	-4.6 (-3.7)
(Facilities investment)	8.2	9.3	-2.0	-0.4 (1.5)	0.4 (1.1)	0.2 (4.3)	-14.2 (-14.0)
(Construction investment)	0.5	1.4	-2.1	-2.5 (-1.9)	-0.3 (-0.3)	0.1 (0.2)	-3.0 (-5.6)
(Goods exports)	12.9	11.9	4.1	-0.7 (11.1)	2.5 (10.9)	-0.9 (8.5)	-12.6 (-11.6)
(Goods imports)	11.5	10.9	4.6	0.1 (11.8)	3.0 (10.0)	1.2 (10.6)	-15.7 (-11.6)
GNI	3.9	4.8	-0.8	-1.0 (3.3)	0.9 (2.3)	-3.6 (-2.7)	-1.6 (-5.4)

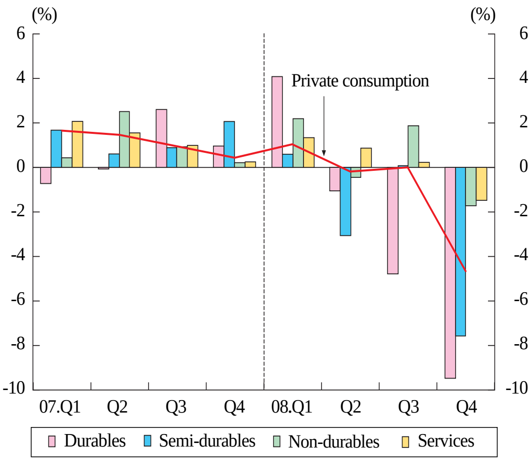
Note: 1) Compared with the previous period. Figures in parentheses are the non-seasonally adjusted year-on-year rates.
Source: The Bank of Korea.

Demand

Looking at the components of demand, private consumption, which in the third quarter had remained at the same level as in the preceding quarter (while increasing 1.4% year-on-year), shifted to a quarter-on-quarter decline of 4.6% (3.7% year-on-year) in the fourth quarter, as consumer sentiment retreated amid the deepening economic downturn and the worsening labor market conditions. By type of consumption, in the fourth quarter the consumption of durables continued to shrink as in the preceding quarter, and those of non-durables and services both shifted to declines.

Figure Ⅰ-9

Major consumption indicators[1]

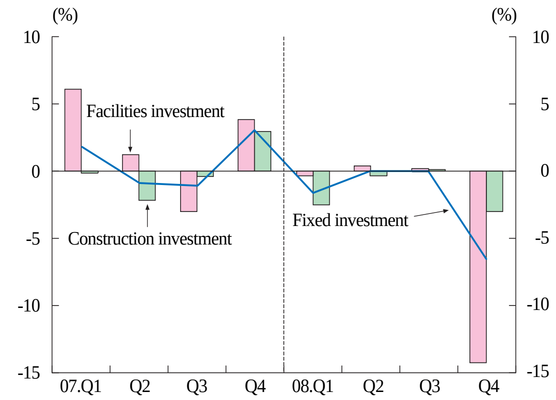


Note: 1) Compared with the previous quarter.
Source: The Bank of Korea.

Facilities investment rose by 0.2% quarter-on-quarter (4.3% year-on-year) in the third quarter, but in the fourth

Figure Ⅰ- 10

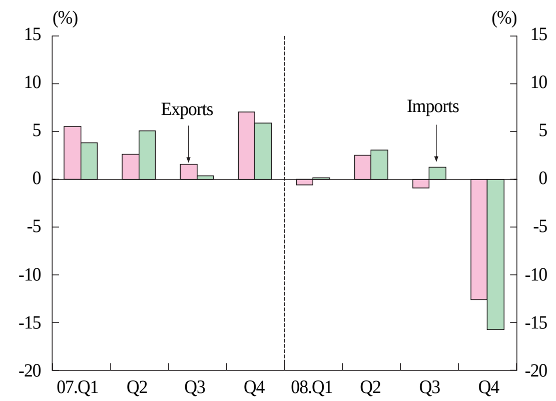
Major investment indicators[1]



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

Figure Ⅰ- 11

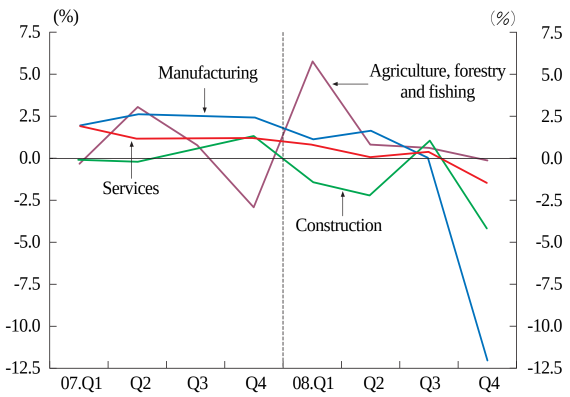
Growth[1] of goods exports and imports



Note: 1) Volume basis. Compared with the previous quarter.
Source: The Bank of Korea.

Figure Ⅰ- 12

Growth[1] by major industries



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

quarter contracted 14.2% (14.0% year-on-year), centering on machinery investment. Construction investment rose 0.1% quarter-on-quarter (0.2% year-on-year) in the third quarter but then shrank 3.0% (5.6% year-on-year) in the fourth quarter amid the deepening depression in building construction.

Exports (goods) showed substantially enlarged scale of reduction, affected by the synchronized global economic recession. Reviewing by quarter, it contracted 0.9% quarter-on-quarter (8.5% increase year-on-year) in the third quarter led downward mainly by automobiles and semiconductors, while in the fourth quarter it accelerated to a 12.6% quarter-on-quarter (11.6% year-on-year) decrease as exports of the majority of items except ships declined. Imports (goods) increased 1.2% quarter-on-quarter (10.6% year-on-year) in the third quarter, but in the fourth quarter contracted 15.7% quarter-on-quarter (11.6% year-on-year) in response to the slowdown in imports of communications equipment, iron and steel, and metal products.

Production Activities

In terms of production activities by industry, every industry from manufacturing to services and construction was subdued.

Manufacturing production increased 0.1% quarter-on-quarter (5.6% year-on-year) in the third quarter, but in the fourth quarter it shifted to show a contraction of 11.9% quarter-on-quarter (9.1% year-on-year) owing to production cuts in major sectors including semiconductors, automobiles, and iron and steel. Consequently, the average manufacturing capacity

Table Ⅰ- 3

Average manufacturing capacity utilization ratio

(%)

2007	2008					2009
	Year[p]	Q1	Q2	Q3	Q4[p]	Jan.[p]
80.1	77.2	80.8	80.4	78.3	69.3	61.5

Source: Korea National Statistical Office.

utilization ratio dropped sharply from 78.3% in the third quarter to 69.3% in the fourth quarter, while it slipped further to 61.5% in January this year.

Output in the services sector shifted from the third quarter's 0.5% quarter-on-quarter (2.6% year-on-year) rise to a fall of 1.4% (0.1% year-on-year) in the fourth quarter, impacted by the lackluster performances of wholesale and retail trade, restaurants and hotels, and of transport, storage and communications.

Construction industry production increased 1.1% quarter-on-quarter (1.0% reduction year-on-year) in the third quarter, but in the fourth quarter it decreased 4.2% quarter-on-quarter (6.3% year-on-year). It was because building constructions shrank by a large margin, more than offsetting the effects of an increase in civil engineering. Production in agriculture, forestry and fishing rose 0.6% quarter-on-quarter (4.2% year-on-year) in the third quarter, but in the fourth quarter declined 0.1% quarter-on-quarter (6.4% increase year-on-year) centering around a decline in fishing.

Table Ⅰ- 4

Major employment-related indicators

(million persons, %)

	2007	2008					2009
		Year	Q1	Q2	Q3	Q4	Jan.~Feb.
Economically active population	24.2	24.4	23.9	24.6	24.5	24.4	23.7
(Rate of growth)[1]	1.0	0.5	0.7	0.6	0.6	0.3	-0.1
Economic participation rate[2]	61.8	61.5	61.6	61.6	61.5	61.2	59.4
Number of employed persons	23.4	23.6	23.1	23.9	23.8	23.6	22.8
(Changes)[1]	0.28	0.14	0.21	0.17	0.14	0.05	-0.12
Number of unemployed persons[2]	0.78	0.77	0.74	0.77	0.78	0.79	0.82
(Non-S.A.)	0.78	0.77	0.80	0.77	0.75	0.76	0.89
Unemployment rate[2]	3.2	3.2	3.1	3.2	3.2	3.2	3.4
(Non-S.A.)	3.2	3.2	3.4	3.1	3.1	3.1	3.7
Economically non-active population	15.0	15.3	15.6	14.9	15.2	15.4	16.2
(Rate of growth)[1]	1.1	2.0	1.8	1.7	1.9	2.5	3.2

Notes: 1) Compared with the same period of the previous year.
2) Seasonally adjusted.
Source: Korea National Statistical Office.

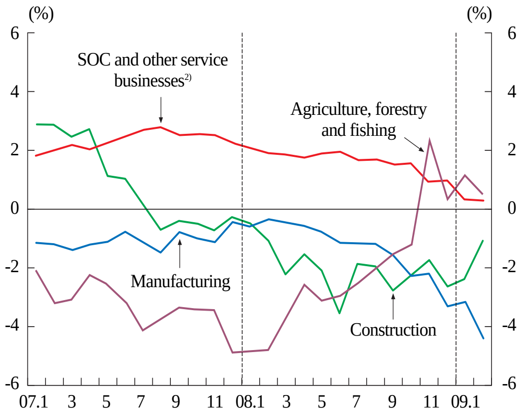
B. Employment and Wages

Employment

Labor market conditions also showed a rapidly worsening pattern due to the economic activity contraction. The scale of year-on-year increase in the number of employed persons shrank from 140,000 persons in the third quarter to 50,000 persons in the fourth quarter. During the first two months of this year, the number of employed persons itself declined by 120,000. The seasonally adjusted economic participation rate also continued to fall from 61.5% in the third quarter to 59.4% during the first two months of this year.

Figure Ⅰ- 13

Growth[1] in the number of employed persons by industry



Notes: 1) Compared with the same period of the previous year.
2) Excludes construction.
Source: Korea National Statistical Office.

Looking at employment by industry, the number of employed persons in the service sector, which led the increase in the overall number of employed persons, showed slowing pace of growth from the third quarter last year, centering on wholesale and retail trade, restaurants and hotels, while that in manufacturing and construction continued to decline. Meanwhile the number of employed persons in agriculture, forestry and fishing showed an upward trend from November onwards.

Table Ⅰ- 5

Ratio[1] of employed persons by employment status

(%)

	2007	2008					2009
		Year	Q1	Q2	Q3	Q4	Jan.~ Feb.
Regular	54.0	55.6	55.4	54.9	56.1	55.9	57.2
Temporary	32.4	31.3	31.7	31.4	31.1	31.1	30.8
Daily	13.6	13.1	12.9	13.6	12.8	13.0	12.1

Note: 1) Share of total waged and salaried workers.
Source: Korea National Statistical Office.

By employment status, as the proportion of temporary and daily-hire employees in total employed persons declined, the ratio of regular full-time waged employees rose from 56.1% in the third quarter last year to 57.2% during the first two months of this year.

Wages

All-industry nominal wages based on businesses employing at least five workers rose 2.6% in the third quarter, but in the fourth quarter declined 2.1%. Real wages deflated by the CPI fell by an increasing margin from the -2.7% in the third quarter to -6.4% in the fourth quarter.

Table Ⅰ- 6

Wage increases[1]

(%)

	2007	2008[2]				
		Year	Q1	Q2	Q3	Q4
Nominal wages	5.6	3.1	6.1	6.3	2.6	-2.1
Real wages	2.9	-1.5	2.2	1.5	-2.7	-6.4

Notes: 1) Compared with the same period of the previous year.
2) Survey coverage, periodicity (month → quarter) and methods have been changed since 2008.
Source: Ministry of Labor.

C. External Transactions

Current Account

After registering a deficit of 8.6 billion dollars in the third quarter, the current account shifted to a surplus of 7.5 billion dollars in the fourth quarter thanks to a

Table Ⅰ - 7

Balance of payments

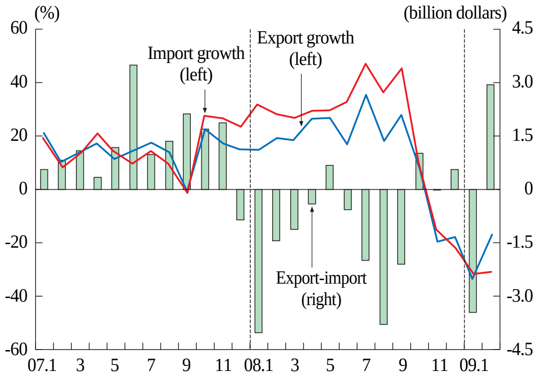
(billion dollars)

	2007	2008p Year	2008p Q1	2008p Q2	2008p Q3	2008p Q4	2009p Jan.
Current account	5.9	-6.4	-5.2	-0.1	-8.6	7.5	-1.4
Goods	28.2	6.0	-1.2	5.7	-3.5	5.0	-1.5
Exports[1]	371.5	422.0	99.4	114.5	115.0	93.1	21.2
Imports[1]	356.9	435.3	106.1	114.8	122.9	91.5	24.9
Services	-19.8	-16.7	-5.1	-4.3	-5.7	-1.7	-0.7
Credit	63.4	76.0	18.2	19.4	19.8	18.6	5.1
Debit	83.1	92.7	23.2	23.7	25.5	20.3	5.8
Income	1.0	5.1	1.7	-0.7	1.4	2.7	0.6
Current transfers	-3.5	-0.8	-0.6	-0.9	-0.8	1.6	0.3
Capital and financial account	7.1	-50.9	0.4	-4.7	-4.9	-41.8	4.9
Financial account	9.5	-50.9	0.6	-4.4	-4.6	-42.5	4.7
Direct investment	-13.8	-10.6	-4.8	-2.9	-2.3	-0.6	-0.1
Portfolio investment	-26.1	-15.4	-10.0	6.0	-12.4	1.0	6.0
Financial derivatives	5.4	-14.3	-1.1	-0.8	-3.5	-9.0	-0.3
Other investment	44.0	-10.6	16.5	-6.7	13.5	-33.9	-1.0
Capital account	-2.4	0.0	-0.2	-0.2	-0.2	0.7	0.1
Changes in reserve assets	-15.1	56.5	3.9	5.7	12.9	34.0	-4.5
Errors and omissions	2.1	0.9	1.0	-0.9	0.6	0.3	1.0

Note: 1) Customs-clearance basis.
Sources: The Bank of Korea, Korea Customs Service.

Figure Ⅰ - 14

Export & import growth[1] and export - import gap



Note: 1) Customs-clearance basis. Compared with the same period of the previous year.
Source: Korea Customs Service.

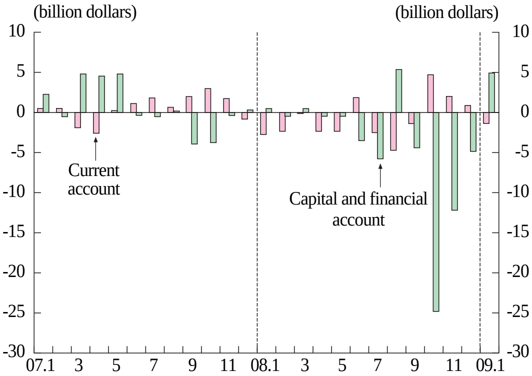
contraction of imports and an improvement in the travel account. For the year 2008 as a whole, a 6.4 billion dollar deficit was registered, the first annual deficit since 1997. In January of this year, the current account showed a 1.4 billion dollar deficit centering around the goods account as a result of seasonal factors.

By component account, the goods account displayed a 3.5 billion dollar deficit in the third quarter owing mainly to the high oil price, but in the fourth quarter registered a surplus of 5.0 billion dollars, reflecting the greater decrease of imports than of exports with the fall of the oil prices and the contraction of economic activity. The services account deficit narrowed from 5.7 billion dollars in the third quarter to 1.7 billion dollars in the fourth quarter, thanks to the improvement in the travel account brought about by the depreciation of the Korean won. The income account surplus widened from 1.4 billion dollars in the third quarter to 2.7 billion dollars in the fourth quarter owing to a reduction in dividend payments. The current transfers account shifted from a deficit of 0.8 billion dollars in the third quarter to a surplus of 1.6 billion dollars in the fourth quarter thanks to an increase in inward remittances.

Exports (customs-clearance basis), after rising 27.0% year-on-year in the third quarter to 115.0 billion dollars, fell 9.9% year-on-year to stand at 93.1 billion dollars in the fourth quarter, owing to the slackness of most major export items apart from ships. Imports (customs-clearance basis) increased 42.8% to 122.9 billion dollars in the third quarter, but then in the fourth quarter dropped 9.0% to 91.5 billion dollars. By category, the reduction in imports as a whole was headed by those of capital goods and consumer durables.

Figure Ⅰ- 15

Current account and capital and financial account



Source: The Bank of Korea.

Table Ⅰ- 8

Major local[1] production-related indicators[2]

(%)

	2007	2008 Year	2008 Q1	2008 Q2	2008 Q3	2008 Q4	2009 Jan.
Manufacturing production index	7.4	3.2	11.4	9.9	5.8	-12.2	-27.0
(Incheon · Gyeonggi area)	8.1	3.2	14.9	13.5	5.0	-16.7	-28.8
(Busan · Ulsan · Gyeongnam area)	4.8	4.3	6.8	7.1	6.2	-2.6	-20.3
(Daejeon · Chungcheong area)	11.2	5.9	12.5	11.7	8.7	-7.4	-22.8
(Gwangju · Jeolla area)	5.8	-0.2	2.6	2.0	3.3	-8.3	-27.1
(Daegu · Gyeongbuk area)	13.9	1.1	13.0	8.6	3.9	-18.2	-33.7
(Gangwon)	1.7	5.5	7.8	10.1	7.5	-2.7	-22.2
(Jeju)	-1.4	8.8	15.5	-5.2	1.4	18.1	-32.4
Non-manufacturing sales BSI	86	82	87	87	83	72	67
Large-scale retail store sales index[3]	5.9	1.0	6.3	3.0	-1.0	-3.4	8.9
Building construction permits	10.5	-20.4	-8.3	-2.5	-12.9	-40.3	··
Building construction initiated	10.8	-24.3	-12.7	-30.1	-25.5	-25.1	··
Construction orders received	20.3	-14.0	-16.0	-14.5	-15.2	-11.9	··

Notes: 1) Excludes Seoul.
2) Compared with the same period of the previous year, except for BSI (base value = 100).
3) Based on constant prices.
Sources: Regional branches of the Bank of Korea, Korea National Statistical Office, Ministry of Land, Transport and Maritime Affairs.

Capital and Financial Account

The scale of the capital and financial account deficit widened substantially, expanding from the 4.9 billion dollars in the third quarter last year to 41.8 billion dollars in the fourth quarter and 50.9 billion dollars for the year 2008 as a whole.

Looking at the component accounts, the portfolio investment account shifted from a 12.4 billion dollar deficit in the third quarter to a 1.0 billion dollar surplus in the fourth quarter, but over the same period the other investment account shifted from a 13.5 billion dollars surplus to a deficit of 33.9 billion dollars, owing to financial institutions' large-scale redemptions of their overseas borrowings. The scale of the financial derivatives account deficit widened from 3.5 billion dollars in the third quarter to 9.0 billion dollars in the fourth quarter, in response to a large increase in financial derivatives product related payments due to the soaring exchange rate.

D. Regional Economic Developments

The Bank of Korea's twelve regional branches monitored regional economic developments on the basis of regional economic statistics and findings derived from some 650 regionally-based enterprises and economic associations. According to these reports, the overall picture of regional economic activity in the latter half of 2008 was one of a rapid contraction, as manufacturing production shifted to a decline and service sector activity also deteriorated particularly from the fourth quarter while construction activity remained in the doldrums.

Manufacturing production shifted from a year-on-year increase of 5.8% in the third quarter to a decline of 12.2% in the fourth quarter. In January of this year, it then fell by 27.0% overall with production in all regions including the Daegu · Gyeongbuk area and the Incheon · Gyeonggi area contracting more than 20%.

In services, the sales index for large-scale retail stores fell by 1.0% year-on-year in the third quarter and 3.4% in the fourth quarter. In January of this year, however, it rebounded, owing to the Lunar New Year holidays falling in that month rather than February and the opening of new outlets. The BSI for non-manufacturing sales fell sharply from 83 in the third quarter to 72 in the fourth quarter, and then further to 67 in January of this year.

In terms of construction activity, building construction permits, building construction initiated and construction orders all continued to contract sharply. In particular, building construction permits declined by 12.9% year-on-year in the third quarter and by 40.3% in the fourth quarter, showing a greatly enlarged reduction.

Labor market conditions also deteriorated further. The scale of the monthly average year-on-year increase in the number of employed persons declined from 171,000 in the third quarter to 125,000 in the fourth quarter, and in January of this year, the number of employed persons itself fell by 31,000. The unemployment rate stood at the same rate of 2.9% in the fourth quarter as in the third quarter, but the economic participation rate fell from 61.7% to 61.3% over the same period. In terms of region, labor market conditions worsened in all regions including the Daejon · Chungcheong area and the Busan · Ulsan · Gyeongnam area.

Table Ⅰ- 9

Major local[1] employment-related indicators[2]

(thousand, %)

	2007	2008					2009
		Year	Q1	Q2	Q3	Q4	Jan.
Number of employed persons[3]	247	163	180	176	171	125	-31
(Incheon · Gyeonggi area)	199	138	197	159	125	72	23
(Busan · Ulsan · Gyeongnam area)	28	21	23	23	35	4	-20
(Daejeon · Chungcheong area)	58	6	25	6	-13	6	-25
(Gwangju · Jeolla area)	1	4	-9	9	3	14	-10
(Daegu · Gyeongbuk area)	-30	-11	-45	-33	10	26	6
(Gangwon)	-9	2	-12	8	5	9	-1
(Jeju)	0	2	2	4	6	-5	-3
Unemployment rate	3.0	3.0	3.1	2.9	2.9	2.9	3.4
Economic participation rate	61.5	61.3	60.1	62.3	61.7	61.3	59.1

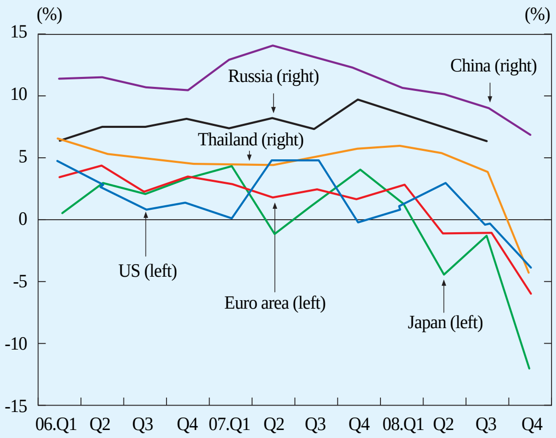
Notes: 1) Excludes Seoul.
2) Non-S.A.
3) Based on the changes compared with the same period of the previous year in all sectors. Monthly-average basis.
Source: Korea National Statistical Office.

< Box I- 1 >

Synchronized Global Recession and Export Slump

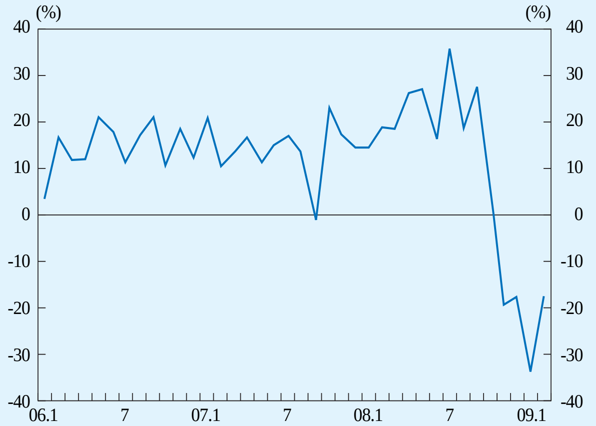
Last year the global economy suffered a synchronized recession. From the second quarter the euro area and Japan, and from the third quarter the US registered negative growth, and then from the fourth quarter the upward trend of growth was blunted markedly in emerging and developing countries. Consequently, exports (customs-clearance basis), which had shown a long-term strong upward trend, shifted to a substantial decline from last November.

GDP growth[1] in selected countries



Note: 1) Figures on the left axis are annualized percentage changes from the preceding quarter. Figures on the right axis are compared with the same period of the previous year.
Sources: Individual countries' published statistics.

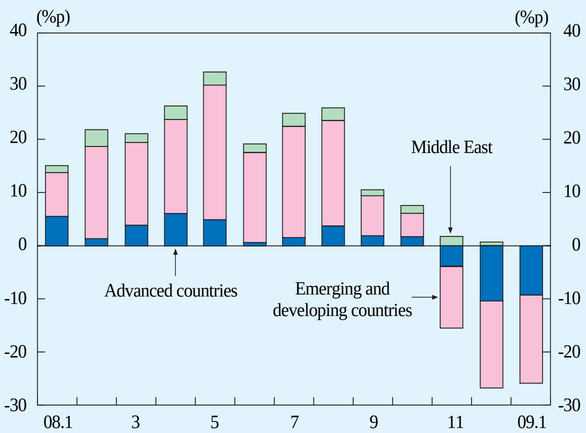
Exports growth[1]



Note: 1) Customs-clearance basis. Compared with the same period of the previous year.
Source: Korea Customs Service.

In terms of contributions to percentage change in exports (daily average basis) by regions from last September, that of the advanced countries reversed from 1.8 percentage points in September to -4.2 percentage points in November and to -9.6 percentage points this January, while that of emerging and other developing countries moved from 7.6

Contributions to percentage change[1] in exports[2] by region



(%, %p)

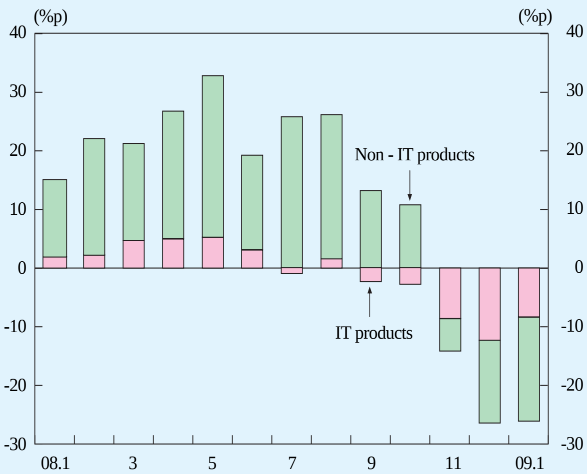
	08.5	6	7	8	9	10	11	12	09.1
▪ Percentage change in total exports	26.9	16.4	35.6	18.1	27.6	7.8	-19.5	-17.9	-33.8
▪ Percentage change in daily average exports	32.5	19.1	24.8	26.0	10.6	7.8	-14.1	-26.5	-26.1
<Contribution to percentage change>									
• Advanced countries[3]	4.8	0.4	1.5	3.6	1.8	1.6	-4.2	-10.5	-9.6
• Emerging and developing countries[4]	25.5	17.1	20.9	20.0	7.6	4.7	-11.6	-16.5	-16.4
• Middle East	2.2	1.6	2.3	2.4	1.2	1.5	1.7	0.6	-0.1

Notes: 1) In daily average exports. Compared with the same period of the previous year.
2) Customs-clearance basis.
3) US, Japan, and the euro area.
4) All other countries apart from advanced countries and Middle Eastern countries.
Sources: Korea Customs Service, Korea International Trade Association.

percentage points to -11.6 percentage points and -16.4 percentage points over the same period. As shown by the figures, the sharp drop in exports from November was driven mainly by the economic downturn in emerging and developing countries. Meanwhile, the contribution to the percentage change in exports by the Middle East also began to decline from last December, and registered -0.1 percentage points in January.

In terms of type of goods as divided into IT and non-IT products, the contribution to the percentage change in exports of non-IT products reversed abruptly from 13.1 percentage points in September to -5.5 percentage points in November and -17.9 percentage points in this January, while IT products enlarged their negative contributions from -2.4 percentage points to -8.6 percentage points and -8.2 percentage points over the same periods. Judging by these figures, the transition to a steep downward trend in exports from November onwards was led by non-IT products centering on automobiles (-6.8 percentage points, contribution this January), chemical products (-2.8 percentage points), and machinery (-2.1 percentage points).

Contributions to percentage change[1] in exports[2] by type of goods



(%, %p)

	08.5	6	7	8	9	10	11	12	09.1
▪ Percentage change in daily average exports	32.5	19.1	24.8	26.0	10.6	7.8	-14.1	-26.5	-26.1
<Contribution to percentage change>									
IT	5.0	3.0	-0.8	1.6	-2.4	-2.8	-8.6	-12.3	-8.2
Non-IT	27.5	16.1	25.6	24.4	13.1	10.6	-5.5	-14.2	-17.9
· Wireless communication apparatus	2.9	1.6	1.0	2.1	1.6	1.4	-1.8	-1.8	-3.4
· Semiconductors	1.0	0.5	-1.5	-0.8	-2.5	-2.6	-3.9	-5.1	-3.4
· Display panels	1.0	1.2	0.4	0.7	0.2	-0.1	-0.7	-2.4	-1.1
· Computers	-0.2	-0.8	-1.3	-1.0	-1.6	-1.4	-1.8	-2.3	-2.1
· Automobiles	1.5	0.8	-0.3	-0.3	-2.5	-1.2	-1.6	-4.9	-6.8
· Chemical products	2.8	3.0	2.9	2.6	1.3	0.1	-2.3	-3.5	-2.8
· Ships	5.8	-2.3	6.3	8.0	5.2	6.4	3.2	4.6	2.2
· Iron & steel products	2.8	2.5	3.5	2.6	2.4	2.0	-0.2	-1.1	-1.4
· Petroleum products	7.4	7.3	8.1	6.6	4.4	1.9	-1.7	-3.8	-2.0
· Machinery	2.3	1.9	1.3	2.1	0.6	0.6	-1.2	-0.9	-2.1
· Other terms	5.3	3.4	4.2	3.3	1.5	0.8	-2.1	-5.3	-3.0

Notes: 1) In daily average exports. Compared with the same period of the previous year.
2) Customs-clearance basis.
Sources: Korea Customs Service, Korea International Trade Association.

Table Ⅰ- 10

Market interest rates[1]

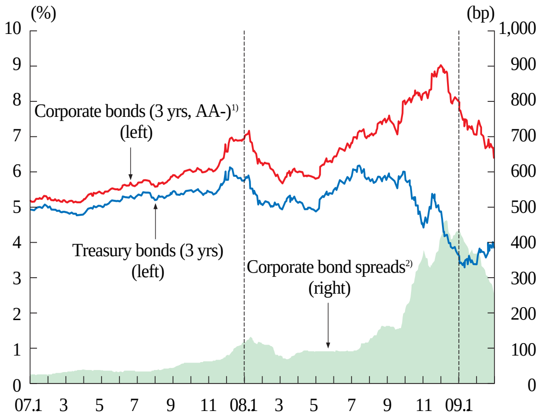
(%)

	2006	2007	2008 Mar.	2008 Jun.	2008 Sep.	2008 Dec.	2009 Jan.	2009 Feb.
Call (overnight)	4.60	5.02	4.98	5.01	5.22	3.02	2.41	1.87
CDs (91 days)	4.86	5.82	5.38	5.37	5.83	3.93	2.96	2.49
CP (91 days)[2]	5.03	6.52	5.77	5.84	6.67	6.49	3.99	3.19
Treasury bonds (3 yrs)	4.92	5.74	5.10	5.90	5.74	3.41	3.59	3.82
Corporate bonds (3 yrs)[3]	5.17	6.90	5.96	6.80	7.88	7.72	7.27	6.37

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 Bond Pricing Corp., NICE Pricing Services Inc.

Figure Ⅰ- 16

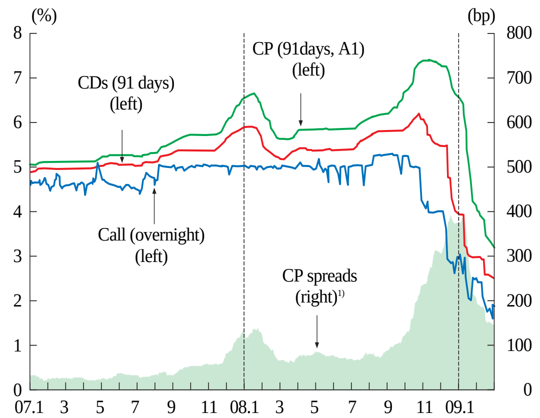
Long-term market interest rates



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

Figure Ⅰ- 17

Short-term market interest rates



Note: 1) CP (91 days, A1) yields - Monetary Stabilization Bond (91 days) yields.
Source: Koscom Corp.

3. Financial Markets

A. Interest Rates and Share Prices

Long-Term Market Interest Rates

In the second half of 2008, market yields on Treasury and corporate bonds exhibited different patterns. Secondary market yields on Treasury bonds (three-year) showed a moderate downward trend from July onwards, and the pace accelerated greatly from October influenced by the reduction in the Base Rate. From the beginning of this year, their yields rose somewhat on expectations of increased issuance of Treasury bonds to register 3.82% as of the end of this February.

Secondary market yields on corporate bonds (AA-, three-year) maintained a steep upward trend from July, climbing to 9.01% on November 28. They subsequently shifted to a declining trend in response to the efforts by the government and the Bank of Korea to stabilize the financial markets, registering 6.37% as of the end of this February. Meanwhile, the spreads of three-year corporate bond (AA-) yields over Treasury bond yields widened to 461 basis points on December 8, and they registered 255 basis points as of the end of February.

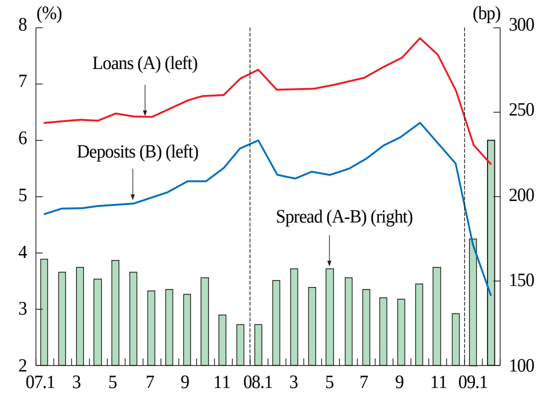
Short-Term Market Interest Rates

Short-term market interest rates, after rising sharply during October last year, showed a rapid decline as the policy authorities moved actively to stabilize the financial markets. Secondary market yields on CDs (91-day), which had risen to 6.18% on October 24, shifted to a downward trend and registered 2.49% as of the end of this February. Secondary market yields on CP (A1, 91-day) eased to 3.19% as of the end of this February after having reached 7.39% on November 4 last year. Meanwhile, the spreads of CP yields over Monetary Stabilization Bond yields widened to 391 basis points on December 16, and then narrowed to reach 145 basis points as of the end of this February.

The overnight call rate fell steeply in line with the reduction in the Base Rate. In the process of the Bank of Korea's expansion of liquidity supply to bring about financial market stability, it sometimes fell below the level of the Base Rate.

Figure Ⅰ- 18

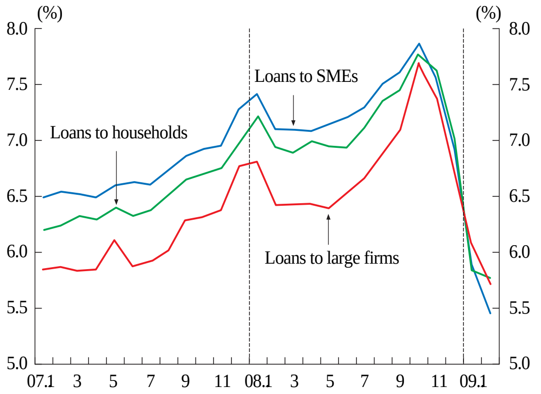
Interest rates[1] on bank deposits and loans, and loan - deposit spread



Note: 1) Based on newly-handled loans and deposits. The figures for February 2009 are preliminary.
Source: The Bank of Korea.

Figure Ⅰ- 19

Interest rates[1] on bank loans by type of borrower



Note: 1) Based on newly-handled loans. The figures for February 2009 are preliminary.
Source: The Bank of Korea.

Banks' Deposit and Lending Rates

Banks' deposit and lending rates shifted to downward trends from last November onwards, reflecting the movements of market interest rates on CDs and bank debentures. Banks' average interest rate on newly-taken savings deposits and their average interest rate on newly-extended loans rose to 6.31% and 7.79% respectively in October, and then eased to 3.24% and 5.57% in this February. The spread between lending and deposit rates exhibited a gradual widening, as banks' fund-raising conditions improved, helped by the increase in time deposits from October.

Viewed by type of borrower, interest rates on loans to both corporations and households shifted to downward trends from November onwards, while those on loans to SMEs fell by a somewhat larger margin owing to banks' extension of loans oriented to companies with strong balance sheet.

Table Ⅰ- 11

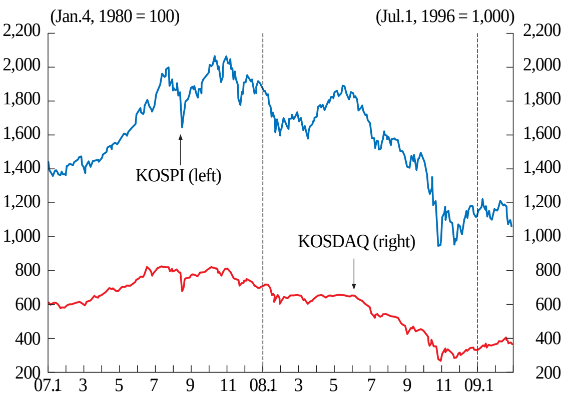
Stock market indicators

	2007	2008			2009
		1st half	Q3	Q4	Jan.~ Feb.
KOSPI[1]	1,897.1 (32.3)	1,674.9 (-11.7)	1,448.0 (-23.7)	1,124.5 (-40.7)	1,063.0 (-5.5)
Trading volume[2] (mil. shares)	363.7	302.0	310.3	503.1	450.5
Trading amount[2] (bil. won)	5,539.6	5,237.4	4,732.8	5,562.1	4,574.3
KOSDAQ index[1]	704.2 (16.2)	590.2 (-16.2)	440.8 (-37.4)	332.1 (-52.8)	363.2 (9.4)
Trading volume[2] (mil. shares)	614.8	482.3	511.3	538.8	657.3
Trading amount[2] (bil. won)	2,035.4	1,406.1	1,134.1	1,037.5	1,505.4

Notes: 1) Period-end basis. Figures in parentheses refer to percentage changes compared with the end of the previous year.
2) Daily average basis.
Source: Koscom Corp.

Figure Ⅰ- 20

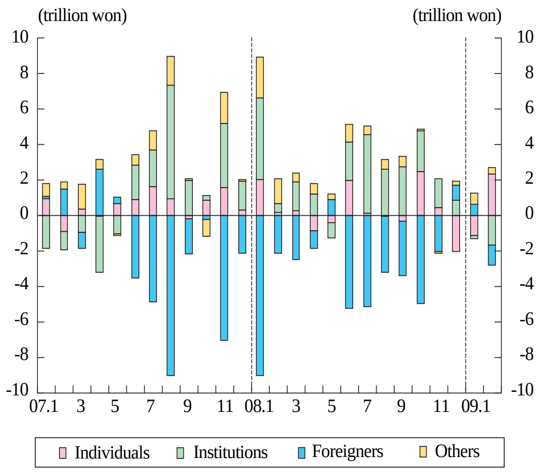
KOSPI and KOSDAQ index



Source: Koscom Corp.

Figure Ⅰ- 21

Net purchases of stocks by type of investor



Source: Koscom Corp.

Share Prices

Share prices retreated on a large-scale in response to the synchronized fall in global share prices and net selling of domestic shares by foreigners in the wake of the heightened global financial market turmoil from late September. This brought the KOSPI down to 938.8 on October 24. The KOSPI subsequently broke from this downward trend to fluctuate in the 1,100 to 1,200 range, helped by the efforts of Korea and other major countries to stabilize the financial markets and bring about a recovery of economic activity. In this February, the KOPSPI showed a downward trend again with the re-emergence of global financial market turmoil, and closed the month at 1,063.0, which was 27.9% down from its level at the end of last August.

The KOSDAQ index showed generally similar movements to the KOSPI. After falling to 261.2 on October 27, it staged a mild rally that brought it to 363.2 at the end of February this year, representing a drop of 22.8% compared with its level at the end of last August.

Looking at the trends of share trading by class of investor, foreign investors maintained net selling positions except for in December of last year and January this year. In consequence, the foreign share in total Korean stock market capitalization declined from 28.9% at the end of last August to 26.6% as of the end of this February. Domestic institutional investors, meanwhile, retained an underlying net purchasing position as pension funds continued their bargain hunting, which offset the effects of the net selling position shown by asset management companies. Individual investors also exhibited a net purchasing position.

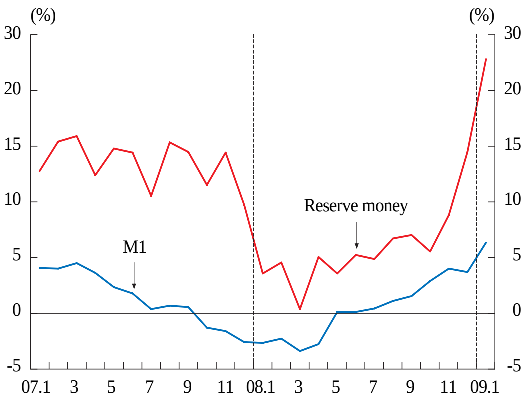
Figure Ⅰ- 22

Growth[1] of L, Lf and M2

Note: 1) Compared with the same month of the previous year. Lf and M2 are on a period-average basis, while L is on a period-end basis.
Source: The Bank of Korea.

Figure Ⅰ- 23

Growth[1] of M1[2] and reserve money



Notes: 1) Compared with the same month of the previous year. Based on the monthly averages.
2) Excludes MMFs.
Source: The Bank of Korea.

B. Monetary Aggregates and Financial Institutions' Deposits

Money Growth

From the latter half of 2008, the scale of increase in SME lending contracted markedly and the upward trend of household lending slowed owing to banks' conservative fund operation in response to worries about credit risk. As a result, the growth rates of M2 (broad money) and Lf (financial institutions' liquidity) fell by considerable margins. In monthly terms, the year-on-year growth rate of L (liquidity aggregate) slowed from 12.7% in June to 12.1% in September and 10.6% in December. Over the same period, the year-on-year growth rate of Lf fell from 12.7% to 12.2% to 10.4%, and that of M2 eased from 15.1% to 14.5% to 13.1%. In January of this year, Lf and M2 growth slowed further to register 9.2% and 12.0% respectively.

In contrast, the year-on-year growth rates of reserve money and M1 (narrow money, excluding MMFs) rose sharply, from 9.1% and 2.7% respectively in September to 17.8% and 5.2% in December, reflecting the Bank of Korea's active policy steps for financial easing. Continuing on into this year, reserve money and M1 recorded growth of 27.4% and 8.3% respectively in January.

Money Supply by Sector

Looking at the money supply of depository institutions by sector, money supply through the government sector expanded from 1.6 trillion won in the third quarter to 4.5 trillion won in the fourth quarter last year in reflection of

Table Ⅰ- 12

Money supply[1] of depository institutions by sector

(trillion won)

	2007	2008				
		Year	Q1	Q2	Q3	Q4
Domestic claims	157.3	258.6	62.6	77.3	82.8	35.9
Government sector	-42.2	-2.9	-19.1	10.1	1.6	4.5
Private sector	199.4	261.4	81.7	67.2	81.2	31.3
(Loans and discounts)	151.0	182.8	51.8	56.4	54.7	19.9
(Securities)[2]	7.8	18.3	8.6	1.8	2.7	5.1
(Shares and other equities)	36.1	-9.0	7.7	0.7	-1.9	-15.5
Foreign sector	48.2	-73.6	-27.5	19.1	-55.4	-9.8
Other sector	-49.2	-13.2	13.6	-31.3	-1.7	6.1
M2	124.3	152.3	42.9	52.0	23.9	33.5
Deposits and securities[3] excluded from M2	31.9	19.4	5.8	13.0	1.9	-1.3

Notes: 1) Changes based on period-end balance.
2) Corporate bonds, CP, etc.
3) Time deposits & installment savings, money trust and financial debentures with maturities of two years or more that are held in depository institutions.
Source: The Bank of Korea.

Table Ⅰ- 13

Deposit-taking[1] by financial institutions

(trillion won)

	2007	2008					2009
		Year	Q1	Q2	Q3	Q4	Jan.~Feb.
Deposit money banks[2]	51.0	95.5	15.1	37.4	23.6	19.4	15.2
Real demand	2.1	1.8	-6.4	3.8	0.8	3.5	3.6
Time & savings	-4.8	70.6	11.1	17.9	14.8	26.8	20.7
(Time)	11.8	61.8	25.2	6.2	10.6	19.9	7.5
(Instant access)	-9.1	9.8	-11.9	11.3	3.7	6.7	12.0
CDs	28.2	7.4	9.6	7.5	-1.2	-8.5	-2.1
RPs[3]	-3.7	-6.3	-3.9	2.4	-0.4	-4.4	-1.9
Financial debentures	29.2	22.1	4.7	5.8	9.6	2.0	-5.1
Banks' trust accounts	9.2	-0.4	7.1	-5.6	0.3	-2.1	-2.3
Specified money trusts	9.1	-1.3	7.7	-5.8	0.5	-3.8	-1.6
Asset management companies	61.8	63.5	37.8	23.9	-16.7	18.5	28.6
MMFs	-10.4	42.2	12.0	12.2	-8.6	26.6	33.3
Equity funds	69.9	23.9	18.6	7.0	0.9	-2.7	-2.1
Bond funds	-9.6	-10.5	1.3	-1.2	-6.6	-4.0	0.6
Hybrid funds	-3.3	-5.4	2.1	0.6	-3.7	-4.4	-2.0
New-type funds	15.3	12.9	3.8	5.3	1.3	2.5	-0.7

Notes: 1) Based on changes during the period.
2) Excludes deposits at the Korea Development Bank.
3) Includes cover bills.
Sources: The Bank of Korea, Korea Financial Investment Association.

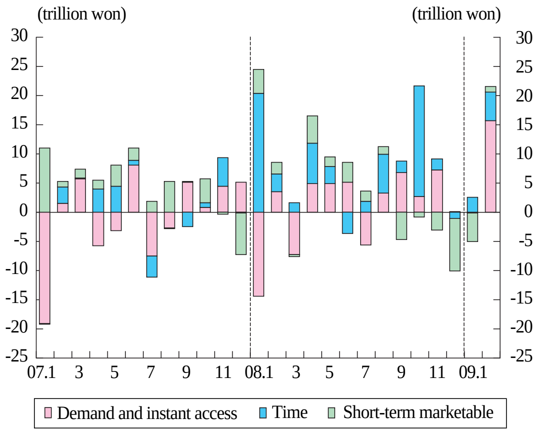
the expansionary fiscal policy. Money supply through the private sector contracted sharply from 81.2 trillion won in the third quarter to 31.3 trillion won in the fourth quarter in response to financial institutions' conservative fund operations and the decline in share prices. In the foreign sector, net absorption in the third quarter was 55.4 trillion won owing to the repatriation of foreign investors' portfolio funds and the deficit in the current account. However, it declined to 9.8 trillion won in the fourth quarter helped by the current account's shift into surplus.

Banks' Deposits

Banks' deposits (bank-account basis) maintained upward trends, with the scale of increase registering 23.6 trillion won in the third quarter last year and 19.4 trillion won in the fourth quarter. By type of deposit, the scale of increase in time deposits expanded from 10.6 trillion won in the third quarter to 19.9 trillion won in the fourth quarter, in line with the strengthening preference for safe-haven assets. Similarly, the scale of increase in real demand deposits and instant access accounts grew from 4.5 trillion won in the third quarter to 10.2 trillion won in the fourth quarter. Marketable deposits such as bank debentures and CDs shifted from an increase of 8.0 trillion won in the third quarter to a decrease of 10.9 trillion won in the fourth quarter, because of the buoyancy of deposit-taking amid the flattening-out of the upward trend in bank lending. During the first two months of this year, time deposits and instant access accounts maintained their upward trends while marketable deposits continued to decline.

Figure Ⅰ- 24

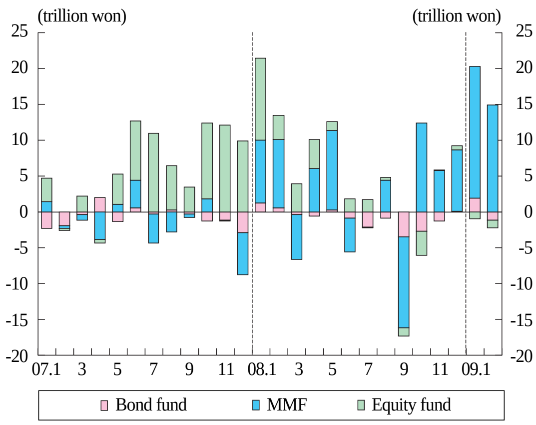
Deposits[1] at banks by product



Note: 1) Based on changes during the month.
Source: The Bank of Korea.

Figure Ⅰ- 25

Deposits[1] at asset management companies by product



Note: 1) Based on changes during the month.
Source: Koscom Corp.

Table Ⅰ- 14

Banks' corporate loans[1]

(trillion won)

	2007	2008					2009
		Year	Q1	Q2	Q3	Q4	Jan.~Feb.
Large firms	8.5	23.6	7.3	5.0	8.4	2.9	1.9
SMEs	65.1	45.0	15.1	19.3	9.2	1.4	5.4
Total	73.7	68.6	22.5	24.3	17.5	4.3	7.3
Privately placed bonds[2]	-6.3	-4.5	-2.0	-1.3	0.0	-1.1	-0.6

Notes: 1) Based on changes during the period. Includes trust account loans, but excludes loans by the Korea Development Bank.
2) Includes bonds issued by public enterprises, but excludes bonds acquired by the Korea Development Bank and foreign bank branches.
Source: The Bank of Korea.

Banks' trust accounts rose by 0.3 trillion won in the third quarter but shrank by 2.1 trillion won in the fourth quarter reflecting corporate demand for year-end funds. They also shrank by 2.3 trillion won in January and February of this year.

Asset Management Companies' Deposits

Deposits at asset management companies increased by a large margin from last October, centering around MMFs. MMFs shrank by 8.6 trillion won in the third quarter, but in the fourth quarter rose by 26.6 trillion won in line with inflows of short-term funds from banks and large firms. Equity funds, amid the dampening of investors' confidence by the fall in stock prices, increased by only 0.9 trillion won in the third quarter, and then decreased by 2.7 trillion won in the fourth quarter. Bond funds contracted by 6.6 trillion won in the third quarter, influenced by the rise in market interest rates, and then declined by a further 4.0 trillion won in the fourth quarter. During the first two months of this year, similarly, deposits at asset management companies rose by 28.6 trillion won led by a steep increase in MMFs.

C. Corporate Financing and Household Credits

Banks' Corporate Lending

During the latter half of 2008, the upward trend of banks' corporate lending (including that from trust accounts) slowed greatly centering around loans to SMEs. SME loans contracted by 9.2 trillion won in the third quarter and a further 1.4 trillion won in the fourth quarter reflecting banks' conservative fund operation in response to worries about credit risk. The expansionary trend in lending to large firms gathered pace in the third quarter, when it increased by 8.4 trillion won, but in the fourth quarter it increased just 2.9 trillion won. In January and February 2008, corporate lending increased by 7.3 trillion won led by SME loans.

Direct Financing

Table Ⅰ- 15

Corporate fund-raising by direct financing

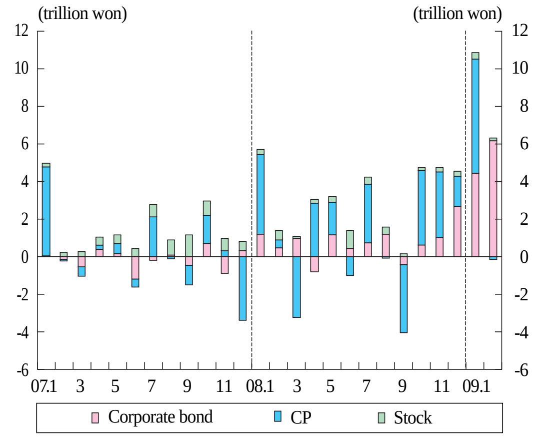
(trillion won)

	2007	2008					2009
		Year	Q1	Q2	Q3	Q4	Jan.~ Feb.
Corporate bond issuance (net)[1]	-1.8	9.1	2.6	0.8	1.5	4.2	10.5
CP issuance (net)[2]	3.8	13.4	1.4	3.5	-0.6	9.0	5.9
Stock issuance[3]	6.5	4.0	0.9	1.4	1.0	0.7	0.6
Total	8.6	26.5	4.9	5.8	1.9	13.9	17.0

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 bank's trust accounts.
3) Initial public offerings and paid-in capital increases.
Sources: Financial Supervisory Service, Korea Financial Investment Association.

Figure Ⅰ- 26

Corporate fund-raising by direct financing[1]



Note: 1) Based on changes during the period.
Sources: Financial Supervisory Service, Korea Financial Investment Association.

Corporate fund-raising in the direct financial markets (net-increase basis) showed a large-scale increase in the fourth quarter of last year, in line with an improvement in issuance conditions thanks to the positive efforts to ensure orderly markets by the government and the Bank of Korea and to increased corporate demand for external funds owing to the business downturn.

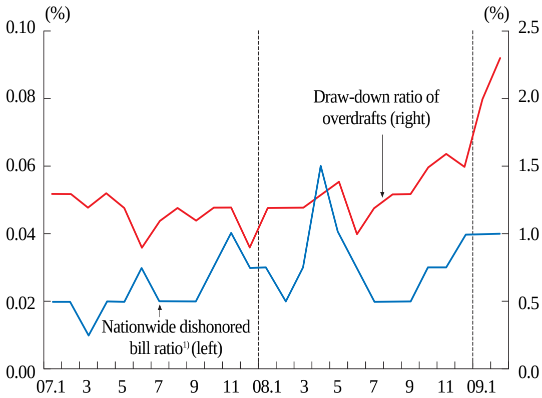
The net issuance of corporate bonds swelled from 1.5 trillion won in the third quarter to 4.2 trillion won in the fourth quarter, while that of CP shifted from a net redemption of 0.6 trillion won to a net issuance of 9.0 trillion won over the same period. Meanwhile, fund-raising through share issues totaled just 1.0 trillion won in the third quarter and 0.7 trillion won in the fourth quarter. In the early weeks of this year, fund-raising through corporate bond and CP issuance was still expanding briskly whereas share issues remained lackluster.

Corporate Financial Conditions

Corporate financial conditions worsened from last October under the impact of the contraction in business activity. The ratio of bills dishonored (after adjustment for electronic settlement) rose from 0.02% last September to 0.04% this January. The arrears rate on

Figure Ⅰ- 27

Major indicators of corporate financial conditions



Note: 1) After adjustment for electronic settlements.
Source: The Bank of Korea.

Table Ⅰ- 16

Household credits[1)]

(trillion won)

	2007	2008				
		Year	Q1	Q2	Q3	Q4
Bank loans	17.5	24.9	4.0	9.3	6.7	4.9
(Mortgage loans)	4.5	18.0	2.7	5.2	5.1	5.1
(Credit loans)	12.9	6.8	1.4	4.1	1.6	-0.2
Non-bank financial institution loans	27.5	28.0	5.6	8.7	8.1	5.7
Merchandise credits	3.7	4.6	0.2	1.9	0.9	1.6
Total	48.7	57.6	9.8	19.8	15.7	12.2

Note: 1) Based on changes during the period.
Source: The Bank of Korea.

Table Ⅰ- 17

Household arrears rates[1)]

(%)

		2007	2008				2009
			Q1	Q2	Q3	Q4	Jan.
Banks	Loans to households	0.8	0.7	0.7	0.7	0.7	0.8
Credit card companies	Subsidiaries of banks	1.7	1.7	1.6	1.8	2.0	2.4
	Stand-alone companies[2)]	3.9 (4.9)	3.3 (3.9)	3.1 (3.7)	2.9 (3.4)	3.0 (3.5)	3.4 (3.9)

Notes: 1) Simple average of monthly overdue ratios (excluding the last month of each quarter).
2) Includes figures for the last month of each quarter. Figures in parentheses include roll-over loans in arrears.
Source: Financial Supervisory Service.

banks' corporate loans rose from 1.3% to 2.3% over the same period.

Household Credits

Banks' mortgage lending increased by 5.1 trillion won in both the third and the fourth quarters, whereas credit loans to households shifted from 1.6 trillion won increase in the third quarter to 0.2 trillion won decrease in the fourth quarter. The expansionary trend of non-bank financial institutions' lending was also blunted, with the scale of its increase reduced to 5.7 trillion won in the fourth quarter from 8.1 trillion won in the third quarter. Despite the contraction in consumption, however, merchandise credit showed a slight expansion in the fourth quarter owing to a seasonal effect.

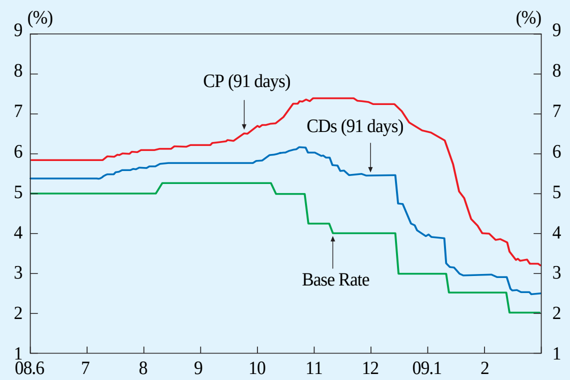
The rate of arrears on banks' household loans remained at 0.7% last year but rose to 0.8% this January. The rate of credit card arrears exhibited an upward path beginning from the third quarter in the case of bank subsidiaries and from the fourth quarter for stand-alone companies.

< Box I- 2 >

Credit Conditions and Flows of Funds in the Financial Markets

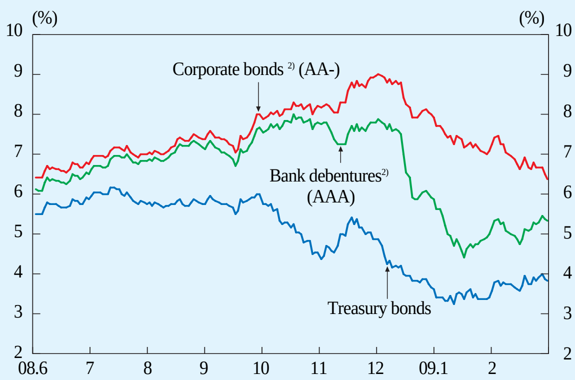
Interest rates on risk-bearing debt securities such as corporate bonds and CP had experienced a large-scale rise owing to the international financial market turmoil and the contraction of the real economy since last September. Those rates fell back markedly from mid-December in response to the Bank of Korea's continuing reductions in its Base Rate and expansion of liquidity supply. While interest rates on risk-bearing debt securities declined, the spreads on corporate bonds according to their credit ratings also narrowed, centering on those on AA and A grade bonds over bonds rated AAA. The improvement in credit conditions, however, remained rather limited as the weight of banks' lending to SMEs in their overall lending declined and the credit risk premium on corporate bonds rated BBB continued at a stubbornly high level.

Short-term market interest rates



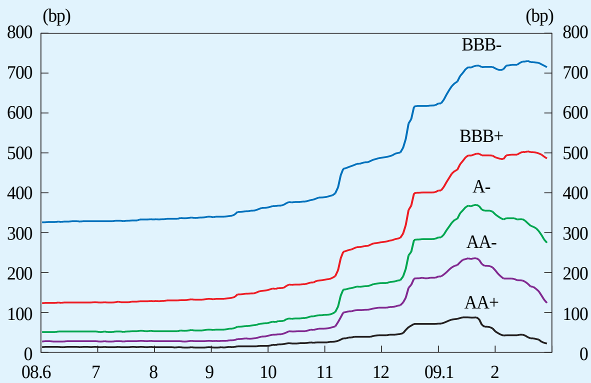
Source: Koscom Corp.

Long-term market interest rates[1]



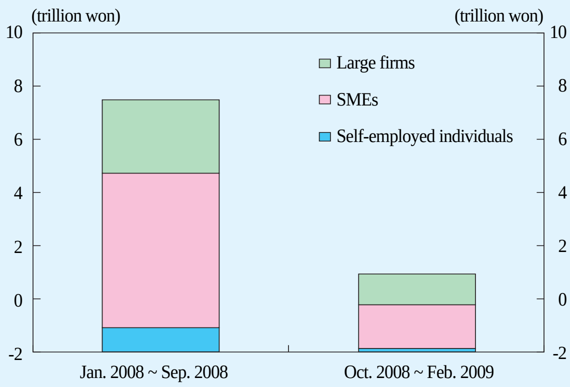
Notes: 1) Three-year maturity basis.
2) Based on the averages of yields estimated by three private credit rating corporations.
Sources: Koscom Corp., KIS Pricing Inc., Korea Bond Pricing Corp., NICE Pricing Services Inc.

Interest rate spreads on corporate bonds by credit rating[1]



Note: 1) Compared with AAA grade bonds, based on the averages of yields estimated by three private credit rating corporations.
Sources: KIS Pricing Inc., Korea Bond Pricing Corp., NICE Pricing Services Inc.

Banks' corporate loans by firm size[1]

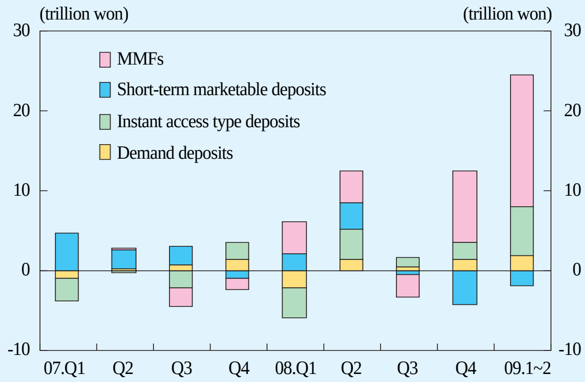


Note: 1) Average monthly change during the period.
Source: The Bank of Korea.

As regards flows of funds, there was a marked increase in financial institutions' short-term deposits. In particular, asset management companies' MMFs increased by 60 trillion won between October 2008 and February 2009. This was almost four times the scale of increase, 16 trillion won, in the first nine months of 2008. The reason for the concentration of funds into MMFs is that yields on them were comparatively higher[1)] than those on other short-term financial products while their safety was also highlighted in that their investments are restricted to short-term assets with high quality[2)].

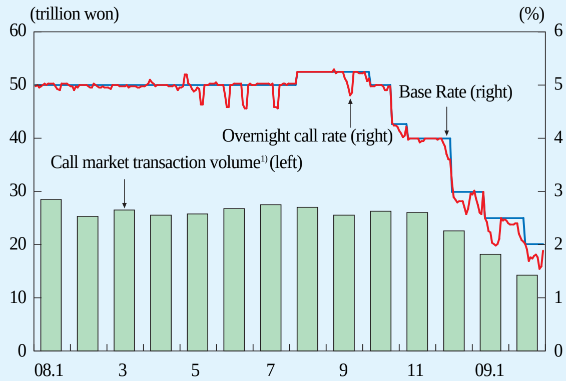
The steep increase in financial institutions' short-term deposits had a direct effect on the call market. Banks' short-term idle funds swelled greatly in line with an increase in asset management companies' overnight bank account loans. As this caused the reductions of demand for call market borrowings, call market transactions declined greatly from December and the overnight call rate sometimes fell below the level of the Base Rate.

Short-term deposits of banks and asset management companies[1)2)]



Notes: 1) Short-term marketable deposits include CDs, RPs and cover bills.
2) Average monthly change during the period.
Sources: The Bank of Korea, Korea Financial Investment Association.

Overnight call rate, the Base Rate and the volume of call market transactions



Note: 1) Daily average basis.
Sources: Korea Money Brokerage Corp., Seoul Money Brokerage Services Ltd.

1) MMFs (7 days) low 4% > MMDA (7 days) around 2% (January 2009).
2) MMFs' eligible securities should belong to one of the two highest short-term rating categories and the maturity of the weighted average of portfolio securities should be less than 90 days.

4. Foreign Exchange Market

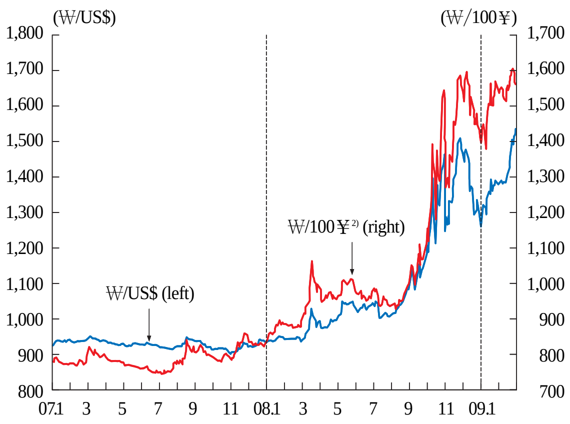
Exchange Rates

The Korean won/US dollar exchange rate rose by a large margin after Lehman Brothers filed for bankruptcy protection last September. Looking at its movements by period, it rose steeply from mid-September owing to the outflow of foreign portfolio funds and the worsening of foreign currency borrowing conditions amid the global financial market turmoil, and the Korean won traded at 1,513.0 per US dollar on November 24. In December, the rate then fell back to the 1,200 won level in response to foreign investors' net buying of stocks, to the surplus in the current account, and to the endeavors of the government and the Bank of Korea to stabilize the foreign currency markets. From the beginning of 2009, however, on concerns about a deterioration of foreign currency supply and demand conditions following the increase in credit risk in Eastern European countries, the exchange rate climbed steeply again to 1,534.0 won per dollar as of the end of February. This represented a 29.0% depreciation of the Korean won compared with the end of August last year.

In the course of the rapid surge of the Korean won/US dollar exchange rate from September onwards, its volatility also soared. In October, its intraday and day-to-day fluctuation ranges registered 66 won and 48 won respectively. From November, its volatility subsided continuously but the level of its fluctuation range in February this year was still wider than that in last August.

Figure Ⅰ- 28

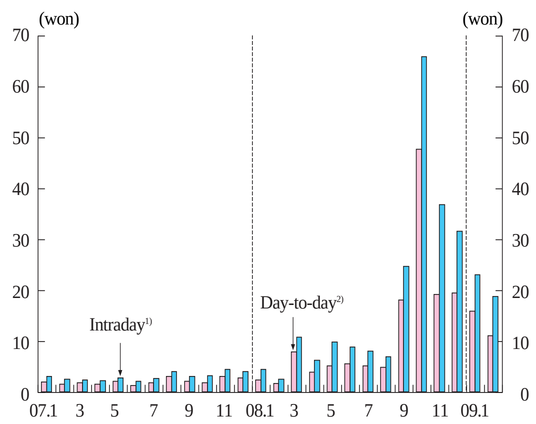
Major exchange rates[1]



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. and Korea Exchange Bank.

Figure Ⅰ- 29

Exchange rate (₩/US$) fluctuations



Notes: 1) Averages of "the intraday highest rate - the intraday lowest rate".
2) Averages of the absolute value of "closing rate for the day - closing rate for the previous day".
Sources: Korea Money Brokerage Corp., Seoul Money Brokerage Services Ltd., and Korea Exchange Bank.

The Korean won/Japanese yen exchange rate rose by an even larger margin than that of the won against the US dollar, as the Japanese yen strengthened against the dollar with the unwinding of yen carry trades. After spiking at 1,598.1 won per 100 yen on December 5, it eased to 1,375.7 won on January 7 this year and then rebounded again to reach 1,570.9 as of the end of this February. This represented a 36.4% depreciation of the Korean won against the Japanese yen compared with the end of August last year.

Foreign Currency Reserves

Table Ⅰ- 18

Foreign reserves[1)]

(billion dollars)

2007	2008				2009
	Jun.	Aug.	Oct.	Dec.	Feb.
262.2	258.1	243.2	212.3	201.2	201.5

Note: 1) Period-end basis.
Source: The Bank of Korea.

The foreign exchange reserves declined by 41.7 billion dollars, from 243.2 billion dollars at the end of last August to 201.5 billion dollars as of the end of this February. This was ascribable to the supply of foreign currency liquidity carried out to stabilize the foreign exchange market and to the decline in the US dollar translation values of assets denominated in euro, UK pound and other major currencies. Major components of the foreign reserves as of the end of this February were securities holdings valued at 177.3 billion US dollars (88.0%), deposits of 23.6 billion US dollars (11.7%), and the country's reserve position with the IMF of 0.6 billion US dollars (0.3%).

Meanwhile, the Bank of Korea expanded the availability of foreign currency by establishing swap arrangements on October 30 with the US Federal Reserve with a ceiling of 30 billion US dollars. The Bank also entered into swap agreements with the Bank of Japan and the People's Bank of China with ceilings of 20 billion US dollars equivalent and 180 billion RMB respectively on December 12.

Overseas Borrowing Environment

Table Ⅰ- 19

Spreads on Foreign Exchange Stabilization Fund (FESF) Bonds and short-term borrowings

(bp)

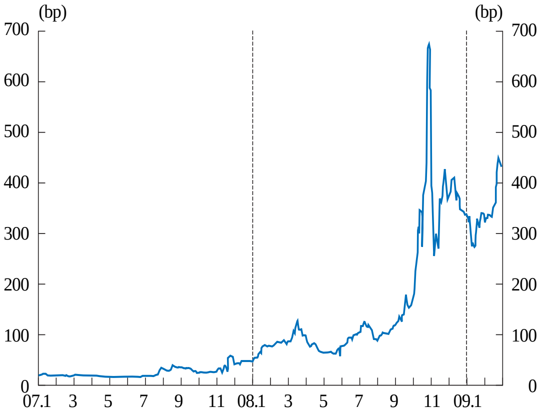
	2007	2008				2009
	Dec.	Jun.	Aug.	Oct.	Dec.	Feb.
FESF Bonds (2013)[1]	118	164	177	422	410	272
Short-term borrowings[2]	31	43	45	166	193	209

Notes: 1) Spreads over T-note, period-end basis.
2) Spreads over LIBOR, period-average basis.
Sources: The Bank of Korea, JP Morgan.

The spread on Foreign Exchange Stabilization Fund Bonds (2013-maturity basis) climbed from 177 basis points as of the end of August to 622 basis points on October 29, in line with the steep run-up in premiums on sovereign bonds of emerging market economies generated by the heightened international financial market unrest. It subsequently narrowed sharply to register 272 basis points as of the end of this February helped by major countries' steps to stabilize the financial markets and the Bank of Korea's entry into a currency swap agreement with the US Federal Reserve. Meanwhile, the premium on domestic banks' short-term foreign borrowings widened from 45 basis points in August to 166 basis points in October and then, reflecting the extended borrowing period, further to 209 basis points in February of this year.

Figure Ⅰ- 30

CDS premium[1]



Note: 1) 5-year maturity, based on New York market.
Source: Bloomberg.

The credit default swap (5-year) premium, which represents the degree of credit risk in international financial markets, spiked at 675 basis points on October 27 as against 116 basis points at the end of August. It subsequently narrowed by a large margin but then widened again to reach 432 basis points as of the end of February, still higher than that at the end of last August, because of Fitch Ratings' downward adjustment[1] of Korea's sovereign and banking rating outlooks in November and concerns in the early weeks of the new year over renewed international financial market turmoil.

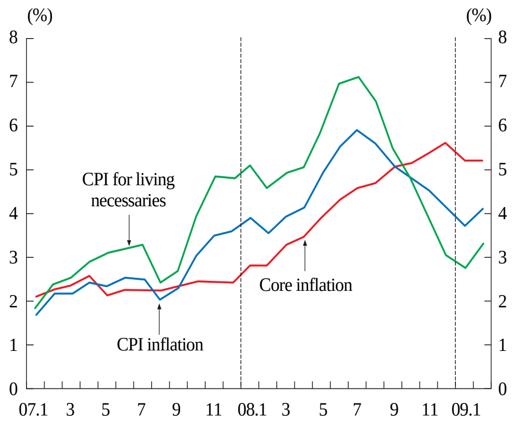
1) Fitch Ratings reviewed its sovereign ratings for 17 major emerging market economies, in consideration of the contagion effects of the economic recessions in advanced economies amid the global financial market turmoil. It revised Korea's sovereign and banking rating outlooks from 'Stable' to 'Negative'.

5. Prices

Consumer Prices

Figure Ⅰ- 31

Consumer prices[1)]



Note: 1) Compared with the same period of the last year.
Source: Korea National Statistical Office.

Table Ⅰ- 20

Consumer prices[1)]

(%)

	2007	2008					2009
		Year	Q1	Q2	Q3	Q4	Jan.~Feb.
Consumer price index	2.5 (3.6)	4.7 (4.1)	3.8 (1.8)	4.8 (2.0)	5.5 (0.6)	4.5 (-0.4)	3.9 (0.8)
Agricultural, livestock and marine products	1.9 (2.6)	0.5 (2.5)	0.0 (-1.2)	0.7 (-0.5)	1.3 (4.3)	-0.1 (-0.1)	5.7 (4.2)
Industrial products	2.0 (4.8)	7.8 (4.9)	5.9 (2.1)	8.6 (5.4)	10.2 (-0.5)	6.7 (-2.0)	4.2 (1.0)
(Petroleum products)	3.0 (17.5)	19.1 (-8.9)	19.5 (3.3)	26.0 (19.1)	28.2 (-8.9)	3.6 (-18.7)	-11.2 (1.9)
(Other industrial products)[2)]	1.6 (2.1)	5.4 (8.4)	2.9 (1.8)	4.7 (2.0)	5.9 (1.9)	7.5 (2.4)	8.1 (0.8)
Services	2.9 (3.0)	3.7 (4.0)	3.3 (2.1)	3.6 (0.7)	4.0 (0.6)	4.0 (0.5)	3.6 (0.2)
(Rents)	1.8 (1.9)	2.3 (2.4)	1.9 (0.6)	2.2 (0.8)	2.4 (0.5)	2.5 (0.6)	2.2 (0.1)
(Public Service charges)	3.1 (3.3)	2.4 (1.8)	3.2 (0.6)	2.7 (0.4)	2.1 (0.2)	1.9 (0.6)	2.0 (0.4)
(Private Service charges)	3.1 (3.3)	4.7 (5.4)	3.6 (3.1)	4.4 (1.0)	5.2 (0.8)	5.4 (0.4)	4.6 (0.2)
CPI for living necessaries	3.1 (4.8)	5.4 (3.0)	4.9 (2.0)	6.0 (2.7)	6.5 (-0.1)	4.0 (-1.6)	3.0 (1.0)
Core inflation	2.4 (2.4)	4.2 (5.6)	3.0 (2.1)	3.9 (1.4)	4.8 (1.1)	5.4 (0.9)	5.2 (0.5)

Notes: 1) Compared with the same period of the previous year. Figures in parentheses refer to the rates of increase of the last month of each period compared with the last month of the previous period.
2) Excludes petroleum products.
Source: Korea National Statistical Office.

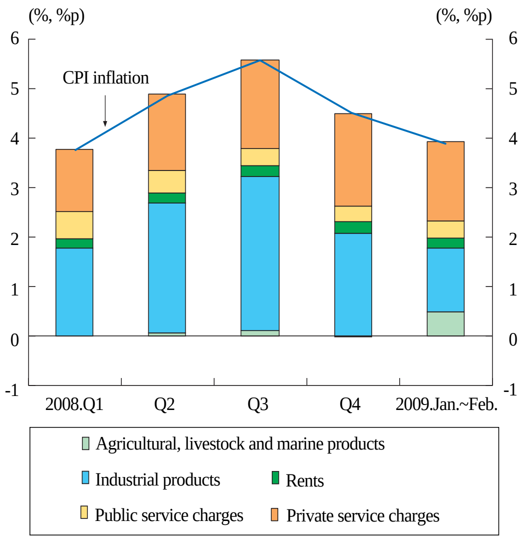
The upward trend of consumer prices softened markedly from the second half of last year, as the effects of business activity weakness were added to the drop in oil and other commodity prices.

By period, the consumer price inflation rate, which had reached a peak of 5.9% year-on-year last July, fell continuously to register 3.7% this January. It then moved slightly up to 4.1% in February driven by the depreciation of the Korean won. By quarter, it dropped continually from 5.5% in the third quarter to 4.5% in the fourth and further to 3.9% in the first two months of this year.

In terms of commodity group, the year-on-year rise in industrial product prices decelerated rapidly from 10.2% in the third quarter to 6.7% in the fourth quarter last year and then to 4.2% this January and February, led by the prices of petroleum products following the fall in international oil prices. The rate of increase in charges for services eased from 4.0% in both the third and fourth quarters last year to 3.6% in the first two months this year, with the stable trends of rents and public service charges offsetting the relatively large scale of the rises in private service charges. The rate of increase in prices of agricultural, livestock and marine products declined from 1.3% in the third quarter to -0.1% in the fourth, before accelerating to 5.7% this January and February led by the prices of livestock and marine products.

Figure Ⅰ- 32

Contributions to CPI inflation[1]



Note: 1) Compared with the same period of the previous year.
Source: Korea National Statistical Office.

Looking at contributions to the rate of increase in the Consumer Price Index (CPI) by major commodity groups, that of industrial products shrank greatly from 3.09 percentage points in the third quarter to 2.06 percentage points in the fourth quarter and 1.29 percentage points in the first two months of this year, serving as the leading factor blunting the upward consumer price inflation trend. While little change was observed in the contribution of service charges, that of private service charges registered 1.61 percentage points, that of public service charges 0.34 percentage points and that of rents 0.21 percentage points in the first two months of this year. The contribution of agricultural, livestock and marine products, meanwhile, stood at 0.48 percentage points in January and February.

The year-on-year rate of increase in the CPI for living necessaries, which focuses on necessities purchased frequently by consumers, fell back continually from its peak of 7.1% in July and stood at 3.3% in February of this year. By quarter, its rate of increase declined from 6.5% in the third quarter last year to 4.0% in the fourth quarter and then to 3.0% in January and February of this year.

Table Ⅰ- 21

Differentials between CPI and core inflation[1]

(%, %p)

	2007	2008					2009
		Year	Q1	Q2	Q3	Q4	Jan.~Feb.
CPI inflation (A)	2.5	4.7	3.8	4.8	5.5	4.5	3.9
Supply shock-related products[2]	3.9	16.4	14.7	19.7	20.9	10.8	4.0
Domestic demand-related products[3]	2.3	3.5	2.4	3.2	3.7	4.2	4.1
Other products[4]	2.4	1.6	1.6	1.5	1.7	1.8	3.5
Core inflation (B)	2.4	4.2	3.0	3.9	4.8	5.4	5.2
Differentials (A - B)	0.1	0.5	0.8	0.9	0.7	-0.9	-1.3

Notes: 1) Compared with the same period of the previous year.
2) Products related with raw materials.
3) Domestic demand-related industrial products, private services (except for raw material-related items) and rents.
4) Agricultural, livestock and marine products, certain processed foods, tobacco and public service charges except for piped-gas.
Source: Korea National Statistical Office.

Core Inflation

The core inflation rate, which strips out the prices of non-grain agricultural products and petroleum products from the CPI, accelerated to 5.6% year-on-year last December but declined from the beginning of 2009 and stood at 5.2% in February. By quarter, after rising from 4.8% in the third quarter to 5.4% in the fourth, core inflation eased to 5.2% in January and February this year. The gap between the consumer price inflation and core inflation rates inverted from 0.7 percentage points in the third quarter to -0.9 percentage points in the fourth quarter and then -1.3 percentage points in the first two months of this year, in line with the large drop in the prices of petroleum products which are excluded from core inflation.

Producer Prices

Table Ⅰ - 22

Producer prices[1]

(%)

	2007	2008					2009
		Year	Q1	Q2	Q3	Q4	Jan.~ Feb.
All items	1.4 (3.6)	8.6 (5.6)	5.1 (2.9)	9.0 (5.8)	12.1 (1.3)	8.0 (-4.3)	4.6 (0.4)
Goods	1.0 (4.0)	10.8 (6.9)	6.1 (3.7)	11.4 (7.4)	15.4 (1.3)	10.2 (-5.2)	5.6 (0.5)
(Agricultural, forest and marine products)	2.8 (2.5)	1.1 (7.9)	-0.3 (2.0)	0.0 (-4.3)	0.5 (2.1)	4.2 (8.4)	11.5 (6.3)
(Industrial products)	0.8 (3.9)	11.9 (7.0)	6.6 (4.1)	12.7 (8.8)	17.3 (1.3)	11.2 (-6.7)	5.3 (0.2)
(Electric power, water and gas)	3.5 (6.4)	4.2 (5.4)	5.0 (-0.7)	4.7 (0.2)	3.4 (0.5)	3.7 (5.4)	5.2 (-1.2)
Services	2.3 (2.3)	2.5 (1.7)	2.4 (0.6)	2.5 (1.2)	3.2 (1.2)	2.1 (-1.3)	1.4 (0.1)

Note: 1) Compared with the same period of the previous year. Figures in parentheses refer to the rates of increase of the last month of each period compared with the last month of the previous period.
Source: The Bank of Korea.

Producer price inflation accelerated to 12.5% year-on-year last July but then fell steeply to stand at 4.4% this February. Looked at by quarter, the rate of increase reached 12.1% in the third quarter then eased to 8.0% in the fourth quarter and 4.6% in January and February of this year.

By commodity group, the year-on-year rise in industrial product prices continued to decelerate from 17.3% in the third quarter to 11.2% in the fourth quarter and then to 5.3% in the first two months of this year, led by petroleum and petrochemical products. The rate of increase in the prices of agricultural, forestry and marine products rose from 0.5% in the third quarter of last year to 4.2% in the fourth quarter and 11.5% in January and February, driven up by the prices of livestock and marine products owing to a reduction in shipments in line with the increase in production costs. The rate of increase in service charges declined from 3.2% in the third quarter to 2.1% in the fourth quarter and 1.4% in the first two months of 2009.

Export and Import Prices

Export prices (Korean-won basis) maintained their steep upward trend in the latter half of last year affected by the

Table Ⅰ- 23

Export and import prices[1]

(%)

		2007	2008					2009
			Year	Q1	Q2	Q3	Q4	Jan.~Feb.
Export prices	Korean-won basis	-2.1 (3.4)	21.8 (25.0)	8.9 (9.6)	21.6 (11.1)	24.8 (3.2)	31.7 (-0.5)	20.8 (1.3)
	Contract-currency basis	-0.3 (1.8)	3.0 (-15.0)	5.2 (3.1)	9.2 (6.2)	8.1 (-5.3)	-10.2 (-18.0)	-17.0 (-2.0)
Import prices	Korean-won basis	4.5 (15.6)	36.2 (22.4)	23.9 (14.5)	41.6 (18.0)	45.3 (-1.1)	33.6 (-8.3)	17.3 (2.1)
	(Raw materials)	7.0 (33.4)	54.6 (0.4)	51.6 (18.2)	78.4 (31.7)	73.8 (-9.7)	20.3 (-28.6)	-4.6 (1.3)
	(Intermediate goods)	4.5 (8.2)	28.5 (31.8)	13.1 (13.2)	26.8 (11.6)	34.2 (4.3)	39.4 (0.0)	26.1 (1.9)
	(Capital goods)	-2.6 (2.5)	23.1 (54.9)	6.6 (9.6)	15.5 (2.1)	17.7 (8.5)	52.1 (27.7)	53.7 (3.7)
	(Consumer goods)	1.2 (8.1)	22.3 (33.3)	10.1 (8.8)	17.7 (4.4)	21.7 (6.4)	39.3 (10.3)	31.5 (4.5)
	Contract-currency basis	7.0 (14.1)	15.2 (-18.2)	19.7 (7.5)	27.3 (13.1)	26.1 (-9.7)	-10.2 (-25.6)	-20.8 (-1.5)
	Exchange rate[2]	+2.8	-15.8	-1.9	-8.8	-13.0	-32.5	-32.5

Notes: 1) Compared with the same period of the previous year. Figures in parentheses refer to the rates of increase of the last month of each period compared with the last month of the previous period.
2) Period-average ₩/US$ basis. Rates of appreciation(+)/depreciation(-) compared with the same period of the previous year.
Source: The Bank of Korea.

rise in the Korean won/US dollar exchange rate. By quarter, they rose 24.8% year-on-year in the third quarter followed by a widening scale of rise of 31.7% in the fourth quarter. Their rate of increase slowed to 20.8% in January and February of this year owing to the slackness of overseas demand.

Import prices (Korean-won basis) showed a deceleration on a limited scale, as the effects of the fall in oil and other commodity prices were partially offset by the rise in the Korean won/US dollar exchange rate. In quarterly terms, their year-on-year rate of increase registered 45.3% in the third quarter, 33.6% in the fourth quarter and 17.3% in the first two months of this year.

On a contract-currency basis, which excludes the effects of exchange rate fluctuations, both export and import prices shifted to steep downward trends from the fourth quarter of last year, influenced by the fall in oil prices and the slowdown in domestic and overseas business activities.

Real Estate Prices

Table Ⅰ- 24

House prices, leasehold deposits and land prices[1]

(%)

	2007	2008					2009
		Year	Q1	Q2	Q3	Q4	Jan.~Feb.
House prices	3.1	3.1	1.4	2.1	0.8	-1.2	-0.8
Apartments	2.1	2.3	1.0	2.1	0.6	-1.5	-1.0
Seoul	3.6	3.2	2.4	3.4	0.3	-2.8	-1.1
(Southern)	0.5	-1.9	0.7	1.3	-0.2	-3.7	-0.9
(Northern)	8.3	9.4	4.5	5.8	0.7	-1.8	-1.3
Leasehold deposits	2.6	1.7	1.1	1.2	0.7	-1.3	-1.2
Apartments	1.9	0.8	0.8	1.0	0.6	-1.6	-1.5
Seoul	2.2	-1.8	1.2	0.9	0.2	-3.9	-1.5
Land prices	3.9	-0.3	1.2	1.5	1.2	-4.1	-0.8[2]

Notes: 1) Compared with the last month of the preceding period.
2) January only.
Sources: Kookmin Bank, Ministry of Land, Transport and Maritime Affairs.

House prices continued to fall from last October onwards as demand weakened greatly amid the downturn in economic activity. The quarter-on-quarter rate of change in house prices shifted from a 0.8% increase in the third quarter to a 1.2% decrease in the fourth quarter and then registered a 0.8% decrease in the first two months of this year. Leasehold deposits moved in a similar pattern, declining by 1.3% in the fourth quarter and 1.2% in January and February this year.

Land prices, similarly, shifted from a 1.2% quarter-on-quarter increase in the third quarter to a 4.1% decrease in the fourth quarter.

Inflation Expectations

Inflation expectations, as estimated through the Bank of Korea's regular surveys of economic agents, exhibited gradual downward trends after peaking in the third quarter last year. Inflation expectations gathered from a panel of experts eased from 5.3% in the third quarter to 4.7% in the fourth quarter and 3.2% in the first quarter of this year. The general public's inflation expectations eased from 4.3% in the third quarter to 4.1% in the first quarter of this year, showing a relatively modest deceleration.

Table Ⅰ-25

Inflation expectations[1]

(%)

	2007	2008				2009
		Q1	Q2	Q3	Q4	Q1
Experts[2]	2.6	3.4	3.6	5.3	4.7	3.2
General public[3]	2.9	3.3	3.8	4.3	4.2	4.1

Notes: 1) Results are taken from the monthly survey of ordinary consumers and the quarterly survey of experts working with economic research institutions, securities companies, asset management companies, life insurances companies, and foreign-based investment banks.
2) Averages for the coming quarter and following quarter surveyed in the first month of every quarter.
3) The quarterly averages of the monthly surveys findings as to the rate of inflation for the coming twelve months. The figure for the first quarter of 2009 is the average of the January and February surveys.

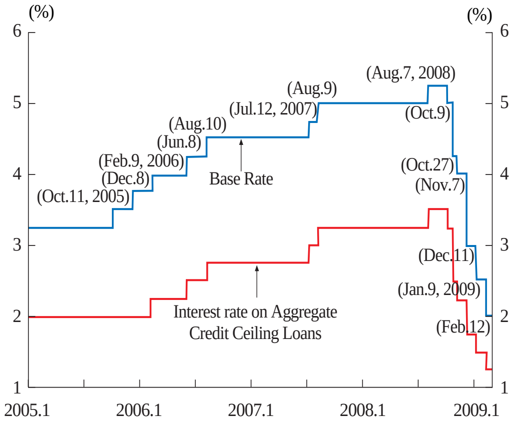
Source: The Bank of Korea.

II. Conduct of Monetary Policy

1. Base Rate

Figure Ⅱ－1

Bank of Korea Base Rate[1] and interest rate on Aggregate Credit Ceiling Loans



Note: 1) Overnight call rate target until February 2008.
Source: The Bank of Korea.

In the wake of Lehman Brothers' filing for bankruptcy protection in September 2008, the Bank of Korea conducted monetary policy with foremost priority on minimizing the negative effects on the domestic financial markets and real economy arising from the worsening overseas environment in the forms of global financial market turmoil and economic recession.

The Bank of Korea, in line with this policy stance, brought its Base Rate down substantially from 5.25% to 2.0%, in six steps between last October and February this year. It also lowered the interest rate on its Aggregate Credit Ceiling Loans from 3.5% to 1.25%.

Large-Scale Base Rate Reduction from October 2008

The Bank of Korea lowered its Base Rate on two occasions in October 2008 by 1.0 percentage point in total. This was followed by cuts of 0.25 percentage point in November, 1.0 percentage point in December and 0.5 percentage point in both January and February 2009. In all, the Bank cut the Base Rate by a total of 3.25 percentage points in a series of six steps. As a result, the Base Rate declined to 2.0%, its lowest level since the policy rate target began to be announced in May 1999.

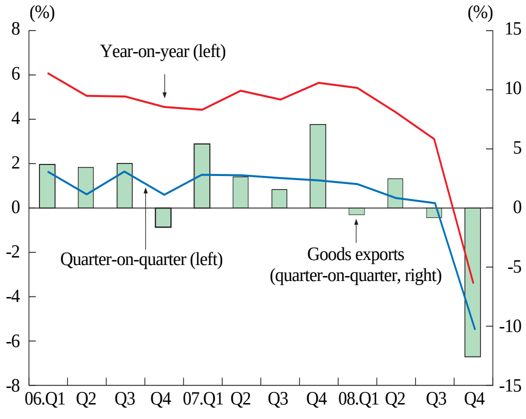
The Bank of Korea's rationale for lowering the policy rate so steeply in such a short period was the need to take positive steps to counter a rapid real economic contraction as the financial and foreign exchange markets had shown disturbingly unstable movements from last September onwards. In particular, it was judged essential to undertake very resolute and swift policy actions to prevent a vicious spiral in which a drop in business activity caused by the financial market unrest brings about even severer financial market turmoil.

Looking at the financial market situation as the background to the decisions on the policy rate, the global financial market turmoil deepened, following Lehman Brothers' filing for bankruptcy protection last September in consequence of which price variables such as interest rates, share prices and exchange rates in the domestic financial markets showed heightened volatility and a credit crunch emerged. Interest rates on risk-bearing debt securities such as corporate bonds and CP marked steep upward trends, with the spreads on corporate bond (AA-, three-year) yields over Treasury bond (three-year) yields widening from 1.62 percentage points at the end of August to 4.61 percentage points as of December 8. In the bank lending market, the scale of the increase in SME lending contracted markedly and the upward trend of household lending slowed, owing to banks' conservative fund operation in response to worries about credit risk. As a result, the growth rates of M2 and Lf fell by considerable margins.

Economic activities declined rapidly from the fourth quarter of last year, with domestic demand in terms of consumption and investment shrinking still further and

Figure Ⅱ - 2

GDP growth

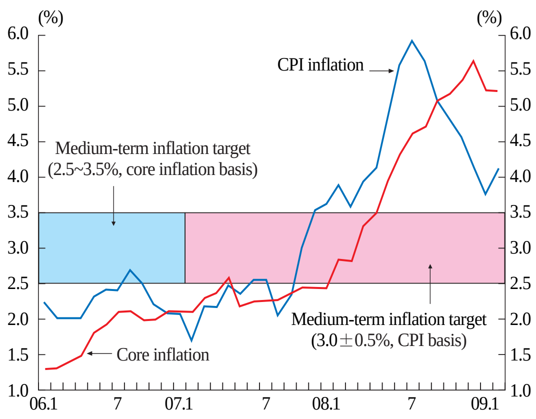


Source: The Bank of Korea.

exports falling sharply. Quarter-on-quarter GDP growth tumbled to -5.1% (-3.4% year-on-year) in the fourth quarter from 0.2% (3.1% year-on-year) in the third quarter. Continuing on into this year, domestic economic activities have kept on contracting in line with the deepening synchronized downturn in both developed and emerging market economies.

Figure Ⅱ- 3

CPI and core inflation[1]

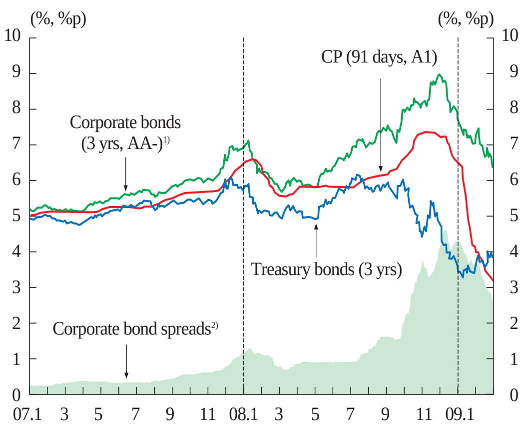


Note: 1) Compared with the same period of the previous year.
Source: Korea National Statistical Office.

The upward trend of prices softened markedly from the second half of 2008 as the effects of business activity weakness were added to the drop in oil and other commodity prices. Consumer price inflation, which had reached a peak of 5.9% year-on-year last July, fell to register 4.1% this February. Core inflation climbed to 5.6% year-on-year last December, but has declined from the beginning of this year and stood at 5.2% in February.

Figure Ⅱ- 4

Market interest rates



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

The Bank of Korea's reduction of its Base Rate exercised an impact on market interest rates and banks' deposit and lending rates with a time lag. Secondary market yields on Treasury bonds shifted to a downward trend as the Bank embarked on its Base Rate reduction, and secondary market yields on CDs also began to decline from the end of October. In addition, interest rates on risk-bearing debt securities such as corporate bonds and CP, which had maintained steep upward trends despite the Base Rate cuts, also fell considerably from mid-December onwards. Consequently, the spreads on corporate bond (AA-, three-year) yields over Treasury bond (three-year) yields stood at 2.55 percentage points as of the end of this February, having narrowed down by more than 2 percentage points compared with the beginning of last December.

Banks' deposit and lending rates also shifted to downward trends from last November onwards reflecting the movements of market interest rates on CDs and bank debentures.

Policy Mix with Fiscal and Foreign Exchange Policy

In its operation of monetary policy, the Bank of Korea also paid close attention to both the government's fiscal policy stance and to exchange rate movements. In response to the economic downturn, the government operated an expansionary fiscal policy, as a result of which the consolidated fiscal account balance showed a large deficit for the second half of last year.

The Korean won/US dollar exchange rate rose steeply from mid-September last year owing to the outflow of foreign portfolio funds and the worsening of foreign currency borrowing conditions amid the global financial market turmoil. This brought the Korean won to 1,513 won per US dollar in late November. In December, the rate fell back to the 1,200 won level in response to foreign investors' net buying of stocks, to the surplus in the current account, and to the endeavors of the government and the Bank of Korea to stabilize the foreign currency markets. From the beginning of 2009, however, on concerns about a deterioration of foreign currency supply and demand conditions following the increase in credit risk in Eastern European countries, the exchange rate climbed steeply again to 1,534 won per dollar as of the end of February.

Table Ⅱ-1

Fiscal balance

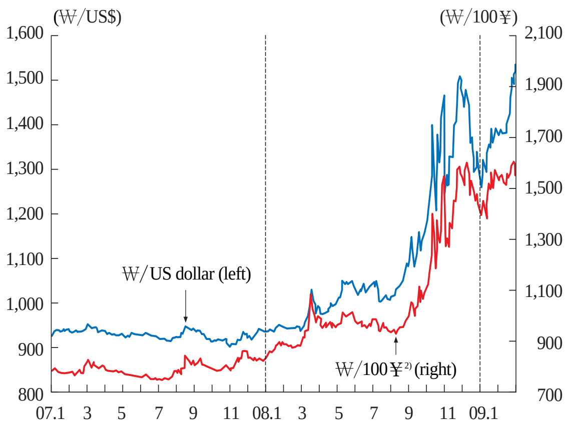
(trillion won)

	2007			2008p		
	Year	1st half	2nd half	Year	1st half	2nd half
Revenue (A)	243.6	124.8	118.8	250.7	141.3	109.4
Expenditure (B)	209.8	113.4	96.4	238.8	119.9	118.9
Adjustment[1] (C)	30.2	16.4	13.8	27.5	17.7	9.8
Fiscal balance (A−B−C)	3.6	-5.1	8.7	-15.6	3.7	-19.3

Note: 1) Balance of social security funds.
Source: Ministry of Strategy and Finance.

Figure Ⅱ-5

Major exchange rates[1]



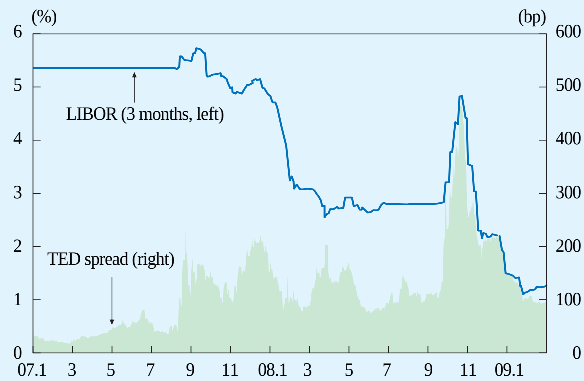
Notes: 1) Closing-rate basis.
2) The basic foreign exchange rate offered to customers posted by Korea Exchange Bank.
Sources: Korea Money Brokerage Corp., Seoul Money Brokerage Services Ltd., and Korea Exchange Bank.

< Box II- 1 >

The Heightened International Financial Market Turmoil and the Policy Response of Major Countries' Central Banks

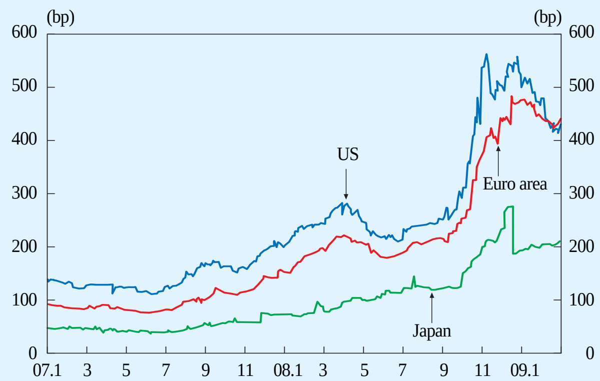
As a result of Lehman Brothers' filing for bankruptcy protection in September 2008, credit risk aversion strengthened further in the international financial markets in line with a sharp increase in counterparty risk. Both the TED spread (LIBOR–T-bill rate, three-month), which indicates banks' credit risk, and the credit spreads on corporate bonds widened greatly. In addition, bank lending became sluggish and the credit default swap (CDS) premium, which indicates sovereign credit risk, climbed steeply centering on that for emerging market countries.

LIBOR and the TED spread



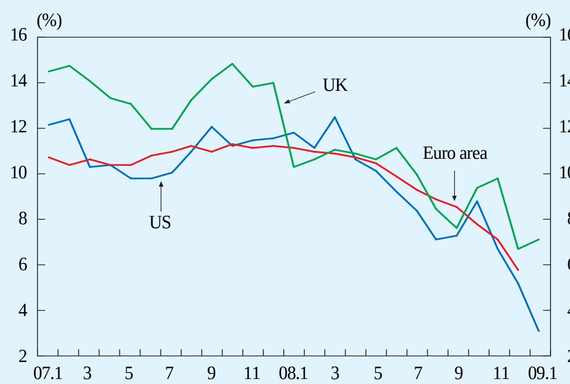
Source: Bloomberg.

Corporate bond spreads[1]



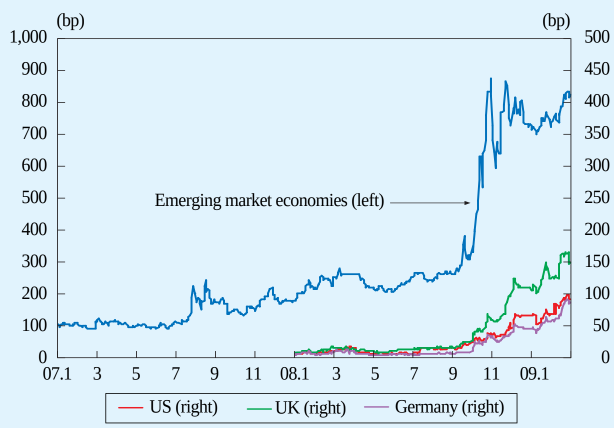
Note: 1) Corporate bond (10 yrs, BBB) yields – Treasury bond (10 yrs) yields.
Source: Bloomberg.

Rate of increase in bank lending[1]



Note: 1) Compared with the previous year.
Sources: FRB, ECB, BOE.

CDS premium



Source: Bloomberg.

In response to this heightened international financial market turmoil, the central banks of major countries lowered their policy rates by large margins, embarking on an active policy of financial easing. The US Federal Reserve lowered the federal funds rate by 175 ~ 200 basis points to 0 ~ 0.25% a year in the wake of Lehman Brothers' filing for bankruptcy protection. The ECB and the Bank of England had also lowered their policy rates by 225 basis points and 400 basis points respectively by the end of this February.

Policy rate adjustment of major countries' central banks

(%, bp)

	End of Dec. 2007	Sep.14, 2008 (A)	End of Feb. 2009 (B)	Adjustment (B-A)
US	4.25	2.00	0~0.25	-200 ~ -175
Euro area	4.00	4.25	2.00	-225
UK	5.50	5.00	1.00	-400
Japan	0.50	0.50	0.10	-40
China[1)]	7.47	7.47	5.31	-216
Australia	6.75	7.00	3.25	-375

Note: 1) One year Base lending rates.
Sources: Individual central banks.

Together with this, policy efforts were also devoted to expanding the supply of liquidity. The US Federal Reserve expanded the scope of the securities eligible as collateral for its Primary Dealer Credit Facility and raised the scale of its Term Auction Facility. It also established liquidity support measures for risk-bearing debt securities such as ABCP, CP, CD, ABS and MBS. The ECB expanded the list of assets eligible as collateral in its credit provision operations and supplied liquidity through long-term RP operations, which differed from its standard RPs. The Bank of England increased the scale of swaps between illiquid assets and Treasury Bills and introduced a Discount Window Facility for the lending of gilts or the supply of funds against the collateral of financial institutions' securities. It established an Asset Purchase Facility as well to enable the purchase of investment grade CP and corporate bonds.

Credit conditions presented an improving pattern from last November, notably in the interbank market in which the TED spread fell sharply, helped by these active market stabilization efforts of central banks in major countries.

2. Financial Market Stability

The Bank of Korea strove actively to restore stability of the financial and foreign exchange markets through a variety of policy instruments including open market operations, lending facilities and reserve requirements.

Liquidity Provision through Open Market Operations

In order to encourage flows of funds into the risk-bearing debt securities market, the Bank of Korea enlarged the scope of eligible securities and eligible financial institution counterparts for its open market operations. Meanwhile, it also provided liquidity support to financial institutions subscribing to the Bond Market Stabilization Fund.

In November and December to facilitate the movement of funds into the bonds market, the Bank included bank debentures and certain government agency bonds among eligible securities for use in open market operations which were originally the Treasury bonds, government guaranteed bonds and Monetary Stabilization Bonds (MSBs). In December, an additional 12 securities companies were selected to join the existing 19 banks, one securities company and Korea Securities Finance Corporation as the Bank of Korea's counterparts for RP transactions.

It was also resolved in November that liquidity support of up to 5 trillion won would be provided by way of open market operations to financial institutions

Table Ⅱ - 2

Expansion of eligible securities for open market operations and counterparts of RP transactions

	Eligible securities	Eligible counterparts
Original	- Treasury bonds - Government guaranteed bonds - Monetary Stabilization Bonds (MSBs)	- 19 Banks (Kookmin, Shinhan, Woori, Hana, SC First, Citi-Korea, Korea Exchange, Korea Development, Industrial Bank of Korea, National Agricultural Cooperative Federation, National Federation of Fisheries Cooperatives, Busan, Daegu, Kwangju, HSBC, Deutsche, JPMorgan Chase, UBS, Calyon) - Woori Investment & Securities, Korea Securities Finance Corp.
Newly added	- Bank debentures[1] - Bonds issued by Korea Land Corporation, Korea National Housing Corporation and Small Business Corporation - Bonds and MBSs issued by Korea Housing Finance Corporation	- 12 Securities companies (Goodmorning Shinhan, Daewoo, Dong Yang, Bookook, Samsung, Shinyoung, Hyundai, HMC, SK, Kyobo, Daishin, Mirae Asset)
	- Valid until Nov.6, 2009	- Valid until Jul.31, 2009

Note: 1) Issued by financial institutions subject to 'Bank Act', Korea Development Bank, Industrial Bank of Korea, National Agricultural Cooperative Federation, National Federation of Fisheries Cooperatives, and Export-Import Bank of Korea.
Source: The Bank of Korea.

subscribing to the Bond Market Stabilization Fund[2). To this end, the Bank supplied a total of 2.1 trillion won in December. Apart from this, it supplied liquidity to banks and securities companies by way of long-term RP operations from October with a view to improving transactions in the CP, CD and bank debenture markets.

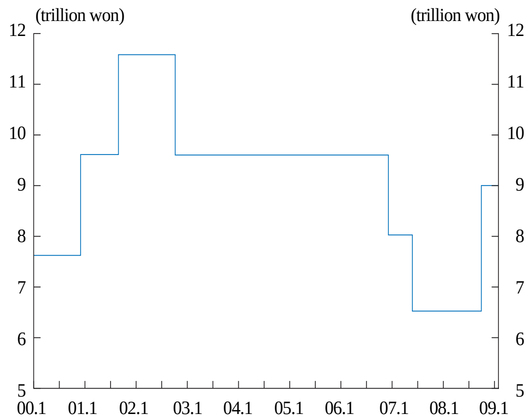
Increase of Aggregate Credit Ceiling and Remuneration for Required Reserve Deposits

The Bank of Korea raised its Aggregate Credit Ceiling, and paid banks interest on their required reserve deposits to facilitate the supply of credit through banks.

The Aggregate Credit Ceiling, which had been lowered several times since 2002, was raised by 2.5 trillion won last November, from 6.5 trillion won to 9.0 trillion won, in order to boost banks' incentives for lending to SMEs. Of the amount of the increase, one trillion won was set as a 'Special Support Ceiling' that could be used to support firms selected by banks under 'Guidelines for the Joint Operation of an SME Fast-Track Program'[3).

Figure Ⅱ - 6

Aggregate Credit Ceiling



Source: The Bank of Korea.

2) Following Lehman Brothers' filing for bankruptcy protection, banks, insurance companies and securities companies set up a fund to supply liquidity preemptively to fragile sectors that could potentially provoke financial unrest including the corporate bond, construction company PF ABCP, and bank debenture markets. The scale of the fund was set at 10 trillion won, to be made up of successive contributions by the financial institutions, and the first round of 5 trillion won was subscribed on December 17, 2008.

3) On October 13, 2008, financial institutions jointly drew up operational guidelines concerning support for the restoration of normal management at SMEs experiencing temporary funding difficulties. In accordance with these guidelines, banks appraise the credit risk of SMEs and, in line with the appraisal results, decide whether to provide liquidity support. Credit guarantee institutions provide guarantees for support.

In December, to help banks expand their credit supply capacity by raising their BIS capital adequacy ratios, the Bank paid[4)] them one-off interest of 500.2 billion won on their required reserve deposits.

As the Bank of Korea embarked actively on financial easing, using a range of policy instruments including open market operations, lending facilities and reserve requirements, the year-on-year rate of reserve money growth (on a period average basis) rose sharply from the 8.7% of last August to 27.4% this January. The net redemption of Monetary Stabilization Bonds (MSBs) occurring in this process caused the outstanding volume of MSBs to shrink from 138.0 trillion won at the end of August to 135.8 trillion won as of the end of February.

Efforts for Foreign Exchange Market Stabilization

The Bank of Korea redoubled its efforts to stabilize the foreign exchange markets.

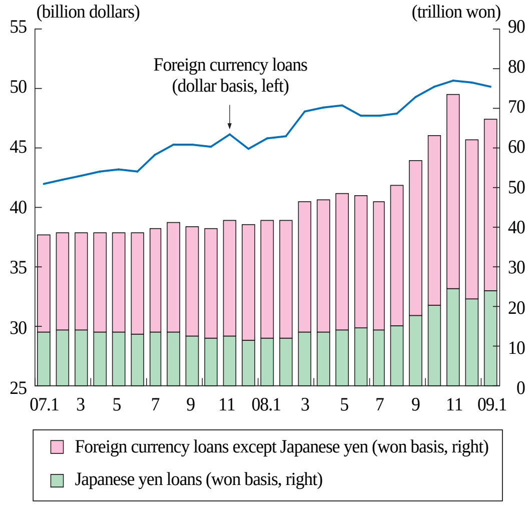
The Bank engaged in the active supply of foreign currency liquidity by way of swap transactions and loans, in order to improve the foreign currency funding conditions for banks experiencing difficulties in overseas fund-raising because of the global financial market turbulence.

The Bank also endeavored to improve the financial circumstances of firms whose business statuses had deteriorated following the sharp rise in the Korean

4) The major advantage of paying interest on required reserve deposits rather than simply lowering banks' reserve requirement ratios was that it had a quick policy effect, by immediately improving bank balance sheets.

Figure Ⅱ - 7

Foreign currency loans by banks



Source: The Bank of Korea.

won/US dollar and Korean won/Japanese yen exchange rates, due to their taking out of foreign currency loans or purchasing currency option products such as KIKOs. From October last year, domestic export firms were allowed to take out foreign currency loans for settlement of currency option contracts such as KIKOs that they had entered into for foreign exchange-risk hedging purposes. The maturity limits were also abolished on foreign currency loans for working capital from December 2008. This action was made considering that the burdens of firms' principal and interest repayment of Japanese-yen denominated loans were not alleviated even though their maturities had been extended on two occasions to a maximum of two years in March and October last year.

In addition, on November 17, the Bank introduced a 10 - billion dollar loan scheme of 'Foreign Currency Loans Secured by Export Bills Purchased' to heighten the attraction to foreign exchange banks of trade financing of SMEs. On December 29, the coverage of this scheme was temporarily extended to include all domestic firms until the end of 2009.

Between October last year and February this year, a total of 15.6 billion US dollars (5.4 billion US dollars excluding the amounts collected at maturity) was supplied by way of swap transactions, and a total of 20.4 billion US dollars (16.4 billion US dollars excluding the amounts collected at maturity) by way of foreign currency-denominated loans.

Entry into Swap Arrangements with Central Banks of Major Countries

The Bank of Korea expanded foreign currency availability by establishing swap arrangements with the central banks of major countries such as the US Federal Reserve.

The Bank entered into a 30-billion US dollar swap arrangement with the Federal Reserve on October 30 and supplied foreign currency liquidity to financial institutions through loans using the proceeds of currency swaps under this facility. In February the arrangement was extended by six months from the original expiry date of the end of April this year until the end of October.

The ceiling on an existing currency swap arrangement[5)] with the Bank of Japan was raised in December from 3 billion US dollars equivalent to 20 billion dollars equivalent, with effect until the end of April 2009. A 3-year currency swap arrangement[6)] to a value of 180 billion yuan was entered into with the People's Bank of China at the same time.

5) Apart from the currency swap within the framework of the Chiang Mai Initiative (CMI) of May 2005, the Bank of Korea and the Bank of Japan had also entered into a bilateral won-yen currency swap for a non-crisis situation, with a maturity date of July 2010.

6) This is separate from the existing currency swap already entered into under the CMI framework.

Heightening the Safety and Efficiency of Payment and Settlement Systems

The Bank of Korea also devoted active efforts to securing the safety and efficiency of the payment and settlement systems.

Immediately after Lehman Brothers' filing for bankruptcy protection last September, the operating hours of BOK-Wire were put on a more flexible basis. Then, from November, they were extended by half an hour with the objective of curtailing system risk arising from the bunching of transactions toward the cut-off time.

In January this year, ahead of the entry into effect from February of the 'Capital Market and Financial Investment Business Act', under which financial investment companies may participate in the retail payment systems through net settlement agents, the Bank of Korea strengthened its management of net settlement risk by updating payment and settlement regulations to take into account the net settlement agent system.

Table Ⅱ - 3

Settlement through BOK-Wire[1]

(number, trillion won)

		2007	2008 Year	2008 1st half	2008 2nd half
Volume	Domestic currency funds transfers	8,264	9,318	9,274	9,359
	(Gross settlement)	7,833	8,878	8,836	8,918
	(Net settlement)	431	440	439	441
	Treasury funds receipt and payment	812	836	784	886
	BOK loans and discounts	23	22	23	22
	Government and public bonds	25	26	27	25
	Total	9,124	10,203	10,108	10,293
	Foreign exchange funds transfers	9	9	10	9
Value	Domestic currency funds transfers	141.3	163.5	158.3	168.4
	(Gross settlement)	128.5	147.6	143.3	151.6
	(Net settlement)	12.8	15.9	15.0	16.8
	Treasury funds receipt and payment	3.0	3.7	3.9	3.5
	BOK loans and discounts	0.7	0.7	0.6	0.7
	Government and public bonds	4.1	4.9	5.0	4.9
	Total	149.1	172.8	167.8	177.5
	Foreign exchange funds transfers (million dollars)	249	259	256	263

Note: 1) On a daily average basis.
Source: The Bank of Korea.

Carrying Out Joint Examinations of Banks

The Bank of Korea, in September and October last year, carried out a general examination jointly with the Financial Supervisory Service (FSS) of the credit business unit in the National Agricultural Cooperative Federation. Also in September, it carried out a partial examination jointly with the FSS of the Seoul Branch of Lehman Brothers Bankhaus, which had been ordered by the Financial Services Commission to cease some parts

Table Ⅱ - 4

Joint examinations with the FSS[1]

(times, number)

	2003	2004	2005	2006	2007	2008
General examinations	11	12	8	8	6	3
Partial examinations	-	-	1 (17)	2 (12)	1 (6)	2 (10)

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

of its operations, in an attempt to grasp the impact of this measure on the financial markets. In November, the Bank carried out checks on the Korean-won and foreign-currency liquidity and credit risk management statuses of nine banks (Woori, SC First, Korea Exchange, Kookmin, Shinhan, Hana, Citibank Korea, Industrial Bank of Korea, and National Agricultural Cooperative Federation).

Strengthening of Policy Cooperation for Financial Market Stability

The Bank of Korea strengthened information sharing and policy cooperation with the government and the financial supervisory authorities in its pursuit of financial market stability. The Bank strove to lay out policy proposals and to bring about policy cooperation with these policy institutions, while sharing information and understanding concerning the state of the financial market and the economy at home and abroad through regular and ad-hoc meetings.

In particular, since the ongoing financial market unrest has the character of a global crisis, a G20 task force and a specialized section were established to facilitate international policy coordination and close cooperation with the government. Their main objective is to support implementation of the joint declaration on overcoming the global financial crisis at the G20 summit meeting last November.

< Box II- 2 >

Support for Bank Recapitalization by Government and Bank of Korea

As of the end of September last year, the BIS capital adequacy ratio of domestic banks had declined to 10.86% as against 12.31% at the end of the previous year. This was a result of their expansion of corporate lending during the first half of 2008, the increase in the Korean won translation value of their foreign-currency denominated assets following the weakness of the Korean won, and valuation losses on securities holdings in line with the drop in share prices.

Domestic banks' BIS capital adequacy ratio[1)]

(%)

2005	2006	2007	Mar. 2008	Jun.	Sep.	Dec.[p]
12.95	12.75	12.31	11.20	11.36	10.86	12.19

Note: 1) Period-end basis. On the basis of Basel II from 2008.
Source: Financial Supervisory Service.

To address this, banks embarked on building up their capital and the government and the Bank of Korea supported them in these efforts. The banks themselves raised around 16 trillion won through the issue of subordinated bonds and capital increase during the fourth quarter last year. While augmenting the capital of the policy banks through subscription, the government widened the scope of the recognition of hybrid bonds as tier 1 capital so as to facilitate banks' seamless expansion of their capital. The Bank of Korea supported their capital expansion by the payment of interest on banks' required reserve deposits. As a result of these efforts, domestic banks' average BIS capital adequacy ratio rose sharply to stand at 12.19% at the end of December 2008.

Support for Bank Recapitalization by Government and Bank of Korea

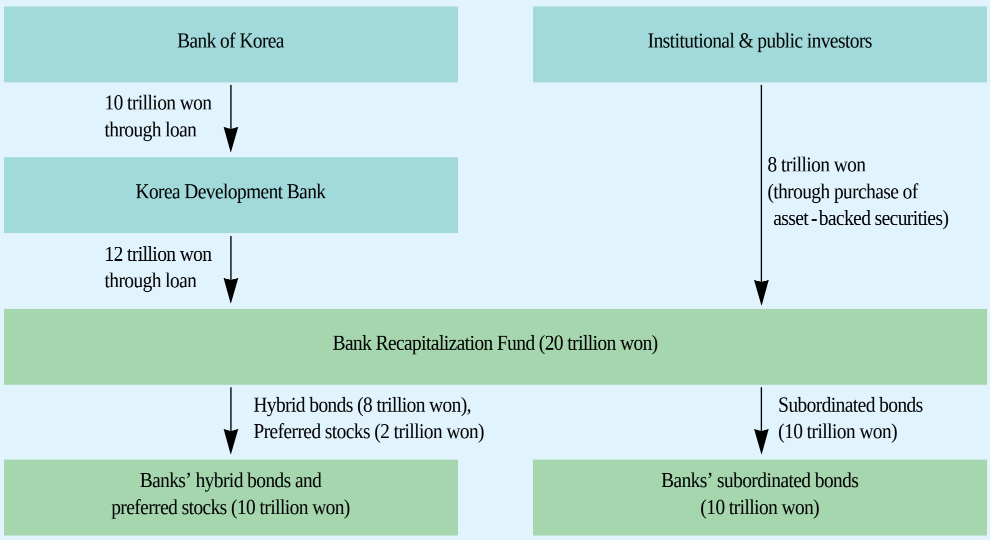
Support	Details (Date of execution)
Subscribing to Policy Banks (Korea Development Bank, Industrial Bank of Korea, Export-Import Bank of Korea).	· 1.65 trillion won (December 18, 2008) · 1.05 trillion won (January 2, 2009) · 0.65 trillion won (January 30, 2009)
Widening the scope of recognition as tier 1 capital of hybrid bonds.	· 15% → 30% (December 29, 2008)
Payment of interest on banks' required reserve deposits.	· 0.5 trillion won (December 11, 2008)

Sources: Financial Services Commission, The Bank of Korea.

Further capital expansion is called for to counter a possible deterioration in banks' capital position as a result of the economic recession and corporate restructuring. The government and the Bank of Korea decided to set up a 'Bank Recapitalization Fund' to help banks build up their capital by purchasing subordinated bonds, hybrid bonds and preferred stocks. The Fund is to consist of a maximum amount of 20 trillion won put up by the Bank of Korea and the Korea Development Bank together with certain institutional and public investors. In this connection, the Bank of Korea resolved to provide funds of up to 10 trillion won to the Korea Development Bank in the form of a loan with a maturity of up to one year. The Korea Development Bank will then provide these funds together with 2 trillion won of its own funds to support the 'Bank Recapitalization Fund'.

The way in which the Fund operates is that a ceiling is assigned upon the receipt of application from banks and funds are supplied within this according to their requirements. In the first round, a ceiling of 12 trillion won was allocated, and the Bank of Korea provided the Korea Development Bank with its first loan amounting to 3.3 trillion won. The government, meanwhile, is intending to induce banks, whose capital has been boosted by the Fund, to use their heightened credit supply capacity for supporting the real economy and promoting corporate restructuring by way of extending new credit lines or roll-overs to SMEs and funding support for companies under workout programs.

Plan for formation of Bank Recapitalization Fund and method of operation



< Box II- 3 >

Currency Swaps between Central Banks

From the beginning of the second half of 2007, the flow of funds between financial institutions showed signs of freezing up as anxieties concerning counterparty risk mounted steeply in the international financial markets, triggered by the US subprime mortgage meltdown. In response to this situation, while introducing a Term Auction Facility (TAF) in December 2007, the US Federal Reserve established currency swap arrangements[1] with the ECB and the Swiss National Bank so as to help provide liquidity in dollars through RP transactions with regional financial institutions. The Federal Reserve's entry into such currency swap arrangements with other central banks is seen to have based on a judgment that, in view of financial globalization, it would be insufficient to stabilize markets to provide liquidity only to depository institutions within the US.

Currency swap arrangements between the US Federal Reserve and other central banks[1]

Country	Date of announcement	Ceiling	Country	Date of announcement	Ceiling
Euro area	Dec.12, 2007	None	Denmark	Sep.24, 2008	15 billion US$
Switzerland	Dec.12, 2007	None	Norway	Sep.24, 2008	15 billion US$
UK	Sep.18, 2008	None	New Zealand	Oct.28, 2008	15 billion US$
Japan	Sep.18, 2008	None	Korea	Oct.29, 2008	30 billion US$
Canada	Sep.18, 2008	30 billion US$	Brazil	Oct.29, 2008	30 billion US$
Australia	Sep.24, 2008	30 billion US$	Mexico	Oct.29, 2008	30 billion US$
Sweden	Sep.24, 2008	30 billion US$	Singapore	Oct.29, 2008	30 billion US$

Note: 1) As of end of February 2009.
Sources: The US Federal Reserve and other central banks.

As global financial turmoil intensified after Lehman Brothers' filing for bankruptcy protection in September 2008, the US Federal Reserve expanded the number of countries, with the central banks of which it had currency swap arrangements, to include the United Kingdom, Japan, Canada, Australia, Sweden, Denmark, Norway and New Zealand, and followed this up by entering into currency swap arrangements with the central banks of emerging market countries such as Korea, Brazil, Mexico and Singapore.

As of the end of February 2009, the US Federal Reserve had entered into currency swap arrangements with the central banks of 14 countries through October 30, 2009. The scale of these currency swap facilities was up to 30 billion dollars for seven countries including Korea and 15 billion dollars for three countries including Denmark, while no limit was placed on the currency swap facilities with the ECB and the central banks of three other countries.

1) The US Federal Reserve set up currency swap lines with the central banks of 14 countries including France and West Germany in the early 1960s. These were actively employed as a means of supporting intervention in the foreign exchange markets under the fixed exchange rate system in the 1960s and the early 70s.

Meanwhile, the Bank of Korea, following the establishment of a currency swap arrangement with the US Federal Reserve, expanded the amount of its arrangement with the Bank of Japan from the existing 3 billion dollars equivalent to 20 billion dollars equivalent and also entered into a 180 billion yuan currency swap arrangement with the People's Bank of China in December, both of which were outside the framework of the Chiang Mai Initiative (CMI).

Currency swap arrangements between the Bank of Korea and other central banks[1)]

Country	Date of announcement	Ceiling	Expiry date	Reference
US	Oct.30, 2008	30 billion US$	Oct.30, 2009	Available for drawdown as required (As of end-February 2009, 16.4 billion dollars had been drawn down)
Japan	Jul.4, 2001 (date of establishment)	Korea→Japan 5 billion US$ Japan→Korea 10 billion US$	Feb.24, 2012	Under CMI
	Dec.12, 2008	20 billion US$ equivalent	Apr.30, 2009[2)]	Available for Drawdown as required
China	May.25, 2005	4 billion US$	Jun.23, 2010	Under CMI
	Dec.12, 2008	180 billion yuan (38 trillion won)	3 years	Available for Drawdown as required
Malaysia	Oct.14, 2005	1.5 billion US$	Jan. 6, 2012	Under CMI
Philippines	Oct.18, 2005	2 billion US$	Oct.16, 2010	Under CMI
Indonesia	Dec.24, 2003 (date of establishment)	2 billion US$	Dec.26, 2009	Under CMI

Notes: 1) As of end of February 2009.
2) For the 17 billion dollars expansion, the expiry date for the existing 3 billion dollars is July 3, 2010.
Source: The Bank of Korea.

2) In May 2000, the CMI was set up as a network of currency swap arrangements between the central banks of East Asian countries (ASEAN+3) which aimed to support the provision of liquidity in the event of financial crisis. Funds through the swaps are to be exercised only in US dollars and to be drawn only in situations confirmed as being an emergency when it is decided or expected that funds will be provided by the IMF.

3. Other Monetary and Credit Policies

Improvement of the Collateral System for Lending Facilities

The Bank of Korea drew up a plan for improvement of the collateral system for its lending facilities, which it then put into effect from February 9 this year.

Credit instruments[7] held by financial institutions were allowed to be used as collateral for Liquidity Adjustment Loans and Intraday Overdrafts, in addition to Aggregate Credit Ceiling Loans. Moreover, by abolishing conditions[8] for eligibility of credit instruments, the Bank of Korea allowed as acceptable collateral all credit instruments with remaining maturities of not more than one year acquired by financial institutions against loans.

A haircut ratio scheme was also introduced. According to this, the collateral value of a marketable security is assessed on a mark-to-market basis, with adjustment by a certain haircut depending upon the remaining maturity and the repayment of principal and interest method. For non-marketable government and public bonds, 80 percent of the face value (the issue price in the case of discounted bonds) is recognized as the collateral value. For credit instruments, 70 percent of the financial institution's loan principal is recognized.

Table Ⅱ - 5

Haircut ratios

Marketable securities		Non-marketable securities	
Remaining maturity[1]	Haircut[2] (%)	Securities	Collateral value (%)
1 year and less	2 (2)	Government and public bonds	80% of face value (issue price in the case of discounted bonds)
3 years and less	3 (4)		
5 years and less	4 (5)	Credit instruments	70% of the financial institutions' loan principal
More than 5 years	5 (6)		

Notes: 1) Remaining maturity is fixed on the day market price is appraised.
2) Coupon bond basis. Figures in parentheses are discount bonds and other securities without coupons.
Source: The Bank of Korea.

7) Promissory notes and bills of exchange accepted by banks when making loans to firms.
8) The eligible credit instruments were limited to those acquired by banks in extending the following types of loans: 1) loans to non-financial businesses, 2) loans for the production and processing of agricultural products, etc., and 3) government-guaranteed loans to agencies acting for the government.

Along with this, the conditions for acquisition of government and public bonds as collateral stipulate that only Korean-won denominated securities, whose principal and interest payment conditions are fixed, are acceptable. In the case of credit instruments, conditions[9) for acquisition were established that take into account the credit status of the issuer and the relationship between the issuer and the financial institution holding them.

Enhancing the Flexibility of Liquidity Adjustment Loans and Deposits

With effect from February 9 this year, the Bank of Korea eased conditions on extending loan maturities and on adjusting the interest rates of Liquidity Adjustment Loans and Deposits, so as to make more flexible use of its standing facilities to stabilize the financial markets. Specifically, it modified its previous phrase in regulations regarding these conditions on extending loan maturities from, ‘Where the Monetary Policy Committee recognizes that the financial markets cannot function normally because of payment and settlement system breakdowns, natural disasters, and so forth,’ to ‘Where the Monetary Policy Committee recognizes maturity extension as necessary for the seamless functioning of the financial markets’.

9) The classification of the related loan should be ‘normal’, and the following credit instruments are not acceptable: 1) credit instruments issued by a majority shareholder, subsidiary or affiliated company of the financial institution, and 2) credit instruments of one issuer exceeding the amount of 10% of the Bank’s total collateral for the specific type of Bank of Korea loan.

Augmenting the Understanding and Credibility of Monetary Policy

The Bank of Korea continued its efforts to heighten the public understanding of monetary policy along with its credibility.

Every month, the Bank hosts a Financial Consultation Meeting, consisting of the chief executive officers of financial institutions, and an Economic Review Meeting, made up of representatives from research institutions and academia. Both of these serve as active channels for feedback on monetary policy.

Endeavors were also directed toward making public economic education targeting youth and the general public more substantial in content. During 2008, a total of 313,000 persons drawn from elementary, middle and high schools, colleges, various institutions and organizations participated in the Bank's offline education program. Online economic education delivered was also enhanced. Economic education web pages for children and teenagers were run efficiently, while new web pages were developed and put up last December providing economic education for college students and the general public. Apart from this, active use was made of the Bank of Korea Museum as a centre for education on currency and the economy.

Table Ⅱ - 6

Performance of the BOK's economic education program in 2008

		Number of program	Number of people
Adults (A)		879	86,164
Lectures	College and graduate students	181	13,367
	Public servants and the police force	69	4,564
	Teachers	53	2,550
	Soldiers	204	33,414
	Others	372	32,269
Youths (B)		2,035	227,209
Lectures	Elementary school	1,191	91,319
	Middle school	386	72,087
	High school	334	58,907
	Others	94	3,781
	Sub total	2,005	226,094
Advanced courses	Economic camps	23	846
	Teacher's courses	7	269
	Sub total	30	1,115
	Total (A+B)	2,914	313,373

Source: The Bank of Korea.

Ⅲ. Monetary Policy Environment and Future Direction

1. Global Economy

A. Economic Growth

The world economy is forecast to experience negative growth in 2009, as advanced economies suffer negative growth while the growth trends in emerging economies decline sharply. Heightened uncertainty in the economy is expected, with the financial market turmoil and the downturn in economic activity reinforcing each other.

Table Ⅲ- 1

Outlook for world economic growth[1)]

(%)

	2008[2)]	2009e		2010e	
		IMF[3)]	OECD	IMF[3)]	OECD
World	3.2	-1.0 ~ -0.5	-0.4[4)]	1.5 ~ 2.5	1.5[4)]
(US)	1.1	-2.6	-0.9	0.2	1.6
(Japan)	-0.6	-5.8	-0.1	-0.2	0.6
(Euro area)	0.8	-3.2	-0.6	0.1	1.2
(China)	9.0	6.7	8.0	8.0	9.2

Notes: 1) Compared with the previous year.
2) Based on IMF statistics, apart from the individual countries and the euro area, which are based on their respective statistics.
3) Published in March 2009 (for China, in January 2009).
4) Members of OECD.

Sources: IMF, World Economic Outlook, January 2009.
Global Economic Policies and Prospects, March 2009.
OECD, OECD Economic Outlook, December 2008.

The US economy is forecast to register negative growth as the sluggishness of consumption and investment intensifies while the financial market unrest persists. Looking at the components of demand, personal consumption expenditure is projected to shrink owing to the deterioration in the labor market and a negative wealth effect. Facilities investment is likely to contract sharply in response to the economic recession and credit crunch, and construction investment is seen to continue its decline led downward by residential investment. US exports are also anticipated to be lackluster affected by the synchronized global economic recession. The large-scale expansion of government fiscal spending is expected, however, to help alleviate the recession.

The Japanese economy is predicted to register negative growth as well, with the decline in exports and sluggishness in domestic demand. Exports are expected to shrink sharply because of the decline in overseas demand. Private consumption is going to remain in the doldrums due to employment instability, and facilities investment is likely to face a deepening slump amid the economic recession and deteriorating corporate profitability.

The euro area economy is also forecast to register negative growth owing to the financial market turmoil, the sluggishness of housing activity, and deteriorating labor market conditions. Private consumption growth is expected to decline sharply because of the labor market instability and the negative wealth effect, while fixed investment will shrink due to the contraction in business confidence in investment and the reduced availability of funding. Exports are also expected to decline with the fall in demand in major trading partners.

The Chinese economy is forecast to slow as exports and domestic demand decline. Exports, which have led economic growth, are forecast to contract rapidly because of the shrinking of import demand in both advanced and emerging economies. Private consumption is also expected to decelerate, impacted by the worsening of labor market and income conditions in spite of the government's aggressive domestic demand stimulus policy. Fixed asset investment is forecast to maintain its upward trend, as the government undertakes a large-scale infrastructure expansion despite the sluggishness of real estate and firms' facilities investment.

Exchange Rates and International Commodity Prices

As the synchronized global economic recession and the international financial market turmoil persist, currencies of major countries are expected to exhibit large volatility, in line with the flight-to-safety and individual countries' economic circumstances and policies taken in response. The predominant forecast is that the US dollar will retain its current strengthening trend against the euro in view of its position as the key currency and the impact of the financial crisis in Eastern European countires, but the possibility is also emerging of it shifting to a weakening trend in view of the widening US fiscal deficit. The Japanese yen has maintained a strengthening trend against other major currencies, but Japan's economic recession and rapidly worsening trade account are expected to act as factors to weaken it.

International oil prices are predicted to stay on a downwardly stable course as demand is expected to decline in response to the global economic recession and speculative capital inflows cannot be easily expected given the persistent global financial market turmoil. Prices of non-oil international commodities are also expected to maintain their underlying weakness amid the sluggishness of demand. Nonferrous metal prices are seen remaining at low levels as a result of the depressed construction and automobile sectors and the build-up of inventories. Grain prices are forecast to remain generally weak due to the reduced demand for their use as biofuels. A widening of their price volatility cannot be ruled out, however, owing to production cuts in response to worsened profitability in the case of nonferrous metals, and to low inventory levels and uncertainty over weather conditions in the case of grains.

Table Ⅲ - 2

Outlook for oil prices[1)]

(US$/barrel)

		2008	2009e					2010e
			Year	Q1	Q2	Q3	Q4	
<Brent>		97.7						
CERA	(Feb. 2)		57.3	56.0	58.0	57.0	58.0	57.8
CGES	(Feb. 23)		53.0	45.5	52.1	56.5	58.0	··
OEF	(Feb. 27)		45.3	43.0	43.0	45.0	50.0	59.0
Barclays Capital	(Feb. 19)		60.0	46.0	53.0	63.0	76.0	84.0
<Dubai>		93.6						
CERA	(Feb. 2)		53.3	52.0	54.0	53.0	54.0	54.7

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

Table Ⅲ - 3

Outlook for non-oil commodity prices[1)]

(%)

	2007	2008	2009e	2010e
IMF	14.1	7.4	-29.1	7.3
OEF	14.1	12.8	-25.4	7.6
European Commission	12.9	13.4	5.9	2.0

Note: 1) Period-average, compared with the previous year.
Sources: IMF, World Economic Outlook, January 2009.
OEF, Commodity Price Monitor, February 2009.
European Commission, Economic Forecast, October 2008.

2. Domestic Economy

For the year 2009, the Korean economy is forecast to register a negative rate of growth, as domestic demand is deeply subdued while exports remain on a declining path amid the global recession.

Private consumption is predicted to shrink still further from its performance last year, in response to the decline in incomes and the weakening of consumer confidence brought about by worsening employment conditions and to the negative wealth effect as well. It is nevertheless anticipated that the private consumption downturn may perhaps be alleviated by the government's expansionary fiscal policy.

Facilities investment is anticipated to remain at a very low level, owing to the worsening of business confidence brought about by the economic downturns at home and abroad, to the increased burden of importing capital goods, and to the deterioration of fund-raising conditions.

Construction investment is forecast to exhibit a mild increase thanks to the expansion of government investment in SOC projects, which should help to offset the slackness of both residential and non-residential building construction.

Exports (in volume terms) are expected to remain on their declining trend due to the deepening of the synchronized global economic recession. Imports (in volume terms), too, are anticipated to decline greatly owing to the shrinking of domestic demand.

The current account is forecast to register a surplus. The scale of the goods account surplus is expected to widen as imports decline on a much larger scale than exports.

Employment conditions are anticipated to deteriorate because of the deepening downturn in economic activity and corporate reconstructuring. It is nevertheless expected that the government's support to keep people employed and efforts to create jobs will ameliorate the situation somewhat.

In the financial markets, the supply of credit is likely to be restricted by the continued global financial market turmoil, the contraction of economic activity, and the uncertainties surrounding corporate restructuring. There is also the constant possibility of episodes of heightened volatility in price variables such as share prices and exchange rates.

3. Prices

The upward trend of prices is expected to be blunted in 2009.

On the cost side, the downward stability of international commodity prices and wages should act to dampen upward price trends, offsetting the effects of currency depreciation. On the demand side, too, the weakening of demand pressures following the business downturn is expected to work to reduce the scale of price increases.

Core inflation is also forecast to slacken its upward pace, centering around the prices of other industrial products and charges for individual services which have been running at a relatively high level.

House prices, meanwhile, are not likely to break away from their stable trend in view of the depressed state of buying sentiment due to the economic downturn, despite the government’s steps to ease the related regulations.

4. Future Monetary Policy Direction

As prices are expected to maintain their stability, the Bank of Korea will conduct monetary policy with a main emphasis on supporting the recovery of economic activity and improving financial market conditions.

The Bank plans to operate the Base Rate in such a way as to maximize its policy effectiveness while keeping a close watch on conditions in the real economy and financial markets.

The Bank will concentrate its policy capacities on bringing about the orderly working of financial intermediation. It will seek to induce flows of funds to sectors suffering from credit supply constraints, through positive application of its open market operations and Aggregate Credit Ceiling Loans. At the same time, it will try to improve credit supply conditions by, for example, providing effective support for banks' efforts to expand their capital. In the event of a further deterioration of financial intermediation, it will prepare proposals for more active supply of liquidity.

Together with this, the Bank intends to prepare a market-friendly exit policy for when financial market conditions are much improved, to phase out use of the wide range of policy instruments introduced in response to the current financial unrest.

In addition, as this is the last year of the three-year inflation target period that started from 2007, the Bank will set a new inflation target this year to take effect from 2010, and review the way in which it will be operated.

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