# Monetary Policy Report

(September 2005)

THE BANK OF KOREA

*September 2005*

*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.*

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# <Overview>

1 In the year 2005 the Bank of Korea continued to conduct monetary policy in such a way as to give support to a recovery of business activity, while putting an emphasis on price stability.

2 In line with this policy stance, the Bank of Korea maintained the call rate target unchanged throughout the first eight months of 2005, after having lowered it to 3.25% in November 2004. In addition, the interest rates on Aggregate Credit Ceiling Loans were held at 2.0% and those on Liquidity Adjustment Loans at 3.0%.

3 This was done in the judgement that it was desirable to maintain the accommodative stance of monetary policy for some time as the pace of economic recovery was very modest, although the real economy showed some signs of improvement while prices remained stable.

4 Viewing the trends of the real economy, at the beginning of the year anticipations mounted that the onset of business recovery would be rather earlier than forecast, as there were indications of improvement in the components of domestic demand such as private consumption, reflecting renewed confidence among economic agents with the rise in share prices, and so on. During the first quarter, however, GDP growth marked a rate of only 2.7% year-on-year and a seasonally adjusted rate of only 0.4% over the previous quarter. This reflected the modest pace of the improvement in private consumption and facilities investment, which was compounded by the slackness of construction investment. From the second quarter onwards, among the components of domestic demand, facilities investment failed to live up to its

anticipated improvement, but a recovery trend of private consumption gradually became tangible and construction investment exhibited an upward trend. And exports continued to grow steadily, though international oil prices rose steeply, and the Korean won maintained its firm trend. As a result, the GDP growth rate for the second quarter rose to 3.3% year-on-year and 1.2% after seasonal adjustment on a quarter on quarter basis. This trend of mild improvement in real economic activity was carried on into the third quarter. The current account, meanwhile, remained in surplus, thanks mainly to the contribution of the goods account surplus, but its scale narrowed to 10.1 billion dollars for the year to July as against its 16.4 billion dollars registered during the same period of the previous year.

5 Prices continued to show downward stability thanks to the weakness of demand-side pressures and the appreciation of the Korean won. Despite the steep rise in the prices of petroleum products owing to high oil prices, service charges and agricultural product prices remained stable. Consequently, from June onwards, consumer price inflation eased to the 2% level year-on-year and the rate of core inflation fell below 2.5%, the lower bound of its target range. On the other hand, there were latent factors making for instability including the persistent run-up in oil prices and the steeply-upward trend of real estate prices.

6 Housing prices had shown a stable trend after the initiation of the countermeasures on 29 October 2003, but late in January 2005, they shifted back to an upward trend as anticipations of renewed rises became widespread, fuelled by a sharp rise in apartment prices in Seoul and surrounding areas. Land prices also rose on a large-scale, particularly in districts in which development plans were being pursued. Accordingly, arguments were put forward for the necessity of adjusting the call rate target upwards. With the business outlook still obscure, however, it was not

considered desirable to adjust the policy rate, which influences all aspects of the economy, for the sake of the stability of real estate prices. In addition, there was a need to observe the effects of the additional controls on housing finance loans put in place at the beginning of July by the financial supervisory authorities and the planned unveiling of the government's comprehensive package of real estate stabilization measures at the end of August.

7 In the financial markets, liquidity conditions was favorable, and banks stepped up the scale of their lending to small and medium enterprises and households compared with the previous year. Long-term market interest rates, which rose sharply at the beginning of the year owing to an imbalance of bond supply and demand, showed a downward trend from mid-February onwards. However they returned to an upward trend from June onwards in response to heightened anticipations of business recovery, and the possibility of an upward adjustment of the call rate target to counter the run-up in real estate prices. Buoyed up by the inflow of long-term investment funds from pension and installment type funds, and anticipations of firms' improved performance, the Korea Composite Stock Price Index (KOSPI) maintained an upward trend during the first eight months of the year apart from a short-lived correction during March and April. This brought it to 1,083 at the end of August, a 21% rise over its level at the end of 2004. Like these, overall financial conditions continued the sustained accommodative trend, and served to benefit the business recovery. On the other hand, concerns were voiced over certain side-effects of the protracted financial easing: the heightened upward pressure on housing prices brought about by the large-scale increase of housing finance loans, and the concentration of financial institutions' funds at the short-term end, which could bring the weakening of financial market stability.

8 The Bank of Korea conducted monetary policy paying attention to a harmonious policy mix with fiscal policy and foreign exchange policy. During the first half of 2005, fiscal policy maintained an expansionary stance in order to promote the recovery of domestic demand. Owing to the frontloading of the disbursement of planned annual expenditures, the disbursement ratio for the first six months was 59.3%, 4.3 percentage points higher than in the corresponding period of the previous year. Consequently the consolidated fiscal balance showed a widening of the scale of its deficit. In response to this, at the beginning of the year, the Bank of Korea decided to adjust the ceiling on the government's temporary borrowings from the Bank to 20.7 trillion won, an increase of 10.07 trillion won from the previous year.

The exchange rate is, in principle, decided by the interplay of supply and demand in the foreign exchange markets. However, the Bank of Korea implements smoothing operations to deal with abrupt swings in the exchange rate caused by temporary imbalances between supply and demand, or radical changes in market sentiment. The Korean won had continued to strengthen against the US dollar in particular from late October 2004 onwards and this trend was maintained into the early part of this year, leading the won to trade at less than 1,000 won per dollar in late April. From mid-June onwards, however, the exchange rate generally fluctuated within a range of 1,010~1,050 won level per dollar due to the strengthening of the US dollar worldwide as a result of the Federal Reserve's steady ratcheting-up of its policy rate.

9 While the Bank of Korea had maintained the call rate target at 3.25%, the Federal Reserve, in contrast, had made continual upward adjustments of the Federal Funds target rate to bring it to 3.5% by August 2005. This gave rise to concerns over possible adverse side-effects such as capital outflow. However, considering that domestic long-term market interest rates remained above US rates by a considerable

margin and overseas investment is accompanied by foreign exchange risk, it was not thought at the present stage that the difference between US and Korean policy interest rates would act as a particularly disturbing factor in the domestic financial and foreign exchange markets. On July 21, the People's Bank of China changed the foreign exchange regime to one based on market supply and demand with reference to a basket of currencies, and adjusted the exchange rate of the yuan from 8.28 per dollar to 8.11 per dollar. This, though, had little impact on Korean financial and foreign exchange markets.

10 In order to maintain the overnight call rate at its target level, the Bank of Korea absorbed, through timely open market operations including the issue of Monetary Stabilization Bonds (MSBs), financial institutions' excess reserves that had been swollen by the sustained current account surplus and the government's frontloading of its fiscal spending. Consequently MSBs outstanding expanded by 17 trillion won from their total at year-end 2004 to 159.8 trillion won as of the end of August 2005. The accumulated issuance of MSBs had been accompanied by side-effects including upward pressure on market interest rates and the increased expenses of issuance. Therefore, in May 2005, as part of a plan to bring them under control, the Bank of Korea introduced currency swap transactions with the National Pension Fund, absorbing Korean won in exchange for foreign reserves to be repurchased at maturity.

11 The Bank of Korea took some measures to give positive inducement to the enlargement of firms' facilities investment, considering that it was a pressing policy task. In July 2005, the Bank of Korea launched a system of currency swaps linked to foreign currency loans, in order to make use of some part of the foreign reserves as a resource for banks' facilities investment lending. In addition, from August, banks' loans of facilities funds to small and medium enterprises were newly added to the

objects of support under the Aggregate Credit Ceiling Facility.

12 Looking at the future operating environment for monetary policy, it is forecast that thanks to the buoyant trend of exports and the recovery of private consumption, the growth rate of GDP during the latter half of the year will rise from the 3.0% of the first six months to around the mid-4 percent level. The current account should retain an underlying surplus, but its scale is seen to narrow further because of the sharp expansion of imports stemming from high oil prices.

Prices should continue to exhibit stable trends. There are, however, a number of latent factors making for instability. These include fears that international oil prices may continue their steep run-up longer than expected and that the ample market liquidity may place upward pressures on prices in the course of the economic recovery.

13 In response to this environment, the Bank of Korea's monetary policy will be directed in such a way as to maintain price stability and to pay attention to the state of business activity. In the event of concern over the emergence of upward pressures on prices in the course of the economic recovery, the Bank of Korea plans to undertake a preemptive response. In order to heighten monetary policy effectiveness further, careful attention will also be constantly paid to its operation in a harmonious policy mix together with fiscal, foreign exchange and financial supervisory policy.

# Ⅰ. Financial and Economic Trends

## 1. Overseas Economies

### A. Economic Growth

During the first half of 2005, the global economy maintained its convincing growth trend centering on the US and China.

The US economy exhibited a solid growth trend that was sustained from the previous year with GDP growth running at 3.6% year-on-year. Private consumption swelled constantly thanks to households' increased borrowing capacity brought about by the rise in house prices and the improvement in employment conditions. Though facilities investment saw its upward trend dip somewhat, private housing construction marked a large scale increase owing to buoyant housing market activity and the pace of export growth accelerated further.

The Chinese economy maintained its trend of rapid growth for the first half of the year and GDP growth registered 9.5% year-on-year. Private consumption exhibited a convincing expansionary trend owing to enlarged spending on housing, education and leisure and entertainment. Fixed investment grew rapidly centering on infrastructure investments related to energy and transport, shrugging off the Chinese government's measures to cool down the overheating of investment. Moreover, exports maintained their swiftly rising trend at around the 30% level, helped by the abolition of textile quotas.

<Table Ⅰ- 1>

**Economic Growth of Major Economies[1)]**

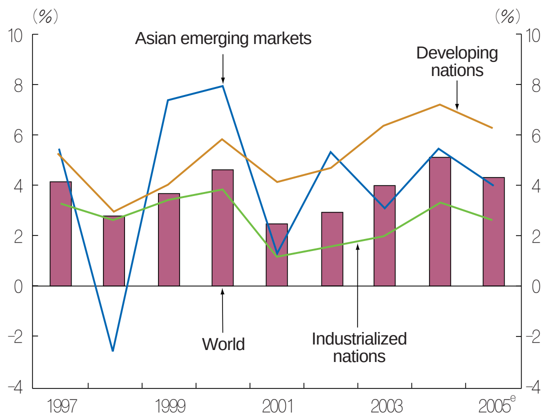
(%)

| | 2003 | 2004 | 2005e | |
|---|---|---|---|---|
| | | | Year | 1st half |
| World | 4.0 | 5.1 | 4.3 | - |
| Industrialized nations | 2.0 | 3.4 | 2.6 | - |
| USA | 2.7 | 4.2 | 3.6 | 3.6 |
| Japan | 1.4 | 2.7 | 0.8 | 1.7 |
| Euro-zone | 0.7 | 2.1 | 1.6 | 1.3 |
| Asian emerging markets[2)] | 3.1 | 5.5 | 4.0 | - |
| Developing nations | 6.4 | 7.2 | 6.3 | - |
| Asia | 8.1 | 8.2 | 7.4 | - |
| (China) | 9.5 | 9.5 | 8.5 | 9.5 |
| Latin America | 2.2 | 5.7 | 4.1 | - |

Notes: 1) Compared with the same period of the previous year. Based on IMF statistics (the figures in 2005 are estimates), apart from certain individual countries and the euro-zone which are based on their respective statistics.
2) Korea, Taiwan, Hong Kong and Singapore.
Source: IMF, World Economic Outlook, April 2005.

<Figure Ⅰ- 1>

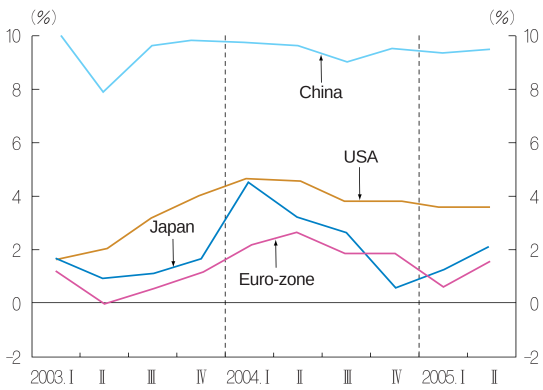
**World Economic Growth**




Source: IMF, World Economic Outlook, April 2005.

**<Figure Ⅰ- 2>**

**Economic Growth[1] of Major Economies**




Note: 1) Compared with the same period of the previous year.

The Japanese economy exhibited stirrings of recovery from last year's downward growth trend. Private consumption showed a smooth recovery thanks to the improvement in the employment situation. Facilities investment was enlarged on the basis provided by improved corporate profitability. The upward trend of exports was blunted somewhat in China-bound exports. Consequently GDP growth rate for the first half of the year registered 1.7% year-on-year.

In the euro-zone, the trend of economic recovery turned lackluster. Although exports increased in response to the weakness of the euro, domestic demand remained in the doldrums with the recovery trend of private consumption faltering and fixed investment slowing. Therefore, the growth rate of GDP during the first half of the year slipped further from the 1.7% of the second half of 2004 to stand at 1.3% year-on-year.

## B. International Financial Markets

**<Table Ⅰ- 2>**

**Long- and Short-term Interest Rates[1]**
**in Major Economies**

(%)

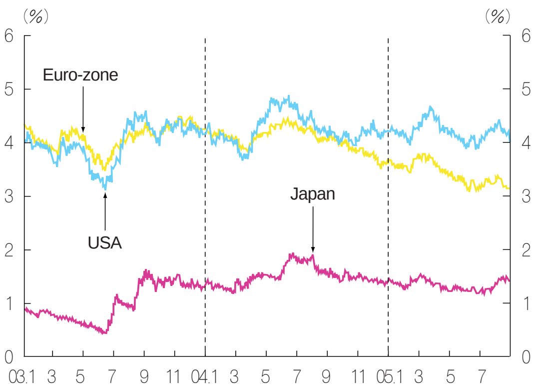
| | 2003 | 2004 | 2005 | | | | |
|---|---|---|---|---|---|---|---|
| | | | Feb. | Apr. | Jun. | Jul. | Aug. |
| Long-term[2] | | | | | | | |
| USA | 4.25 | 4.22 | 4.38 | 4.20 | 3.91 | 4.28 | 4.01 |
| Japan | 1.37 | 1.44 | 1.48 | 1.24 | 1.17 | 1.31 | 1.35 |
| Euro-zone | 4.29 | 3.68 | 3.70 | 3.39 | 3.13 | 3.24 | 3.10 |
| Short-term[3] | | | | | | | |
| USA | 0.92 | 2.21 | 2.75 | 2.89 | 3.12 | 3.39 | 3.50 |
| Japan | 0.001 | 0.001 | 0.001 | 0.001 | 0.001 | 0.001 | 0.001 |
| Euro-zone | 2.12 | 2.16 | 2.14 | 2.13 | 2.11 | 2.13 | 2.13 |

Notes: 1) Month-end basis.
2) Based on 10-year government bond yields.
3) Based on 3-month Treasury bill yields, apart from the euro-zone, which is based on 3-month EURIBOR.
Source: Bloomberg.

From the beginning of 2005, long-term market interest rates in the major countries maintained a generally downward trend apart from a brief rise-up during February and March. Despite the US Federal Reserve's upward adjustment of its policy interest rate, US long-term market interest rates showed a pattern of fluctuations around the previous year-end's level. Seen by period, from the mid-February, they exhibited a sharply upward trend on worries over inflation stemming from the steep run-up in oil prices and the Federal Reserve's interest rate hike. From the end of March onwards, though, they retreated to a downward trend as the likelihood of the Federal Reserve's raising its policy rate aggressively receded owing to worries about a business downturn. During July and August as downside factors, such as the possibility of economic recession resulting from high oil prices, were balanced out by upside factors including the Federal Reserve's continued interest rate hikes, they showed fluctuating movements. As of the end of August, they had shed 21 basis points to stand at 4.01% (yields on 10-year Treasury bonds).

**<Figure Ⅰ- 3>**

**Long-term Interest Rates[1] in Major Economies**




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

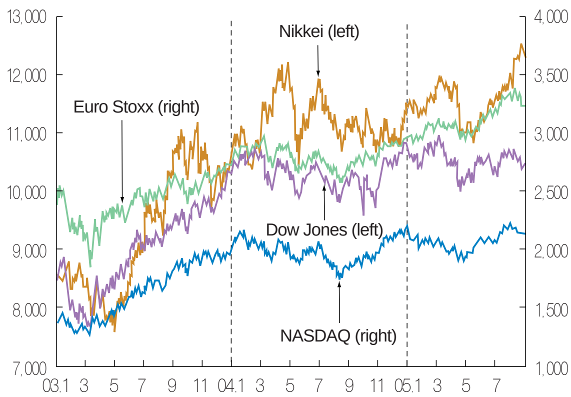
Japanese long-term market interest rates maintained their low level of around 1% while showing a similar pattern of movements to those in the United States. Long-term market rates in the euro-zone exhibited a downward trend that reflected concerns over the delayed economic recovery. Consequently the interest rate spread between euro-zone and US rates widened greatly. As of the end of August long-term market interest rates (yields on 10-year Treasury bonds) in Japan stood at 1.35%, 9 basis points lower than that of the previous year end. Meanwhile, long-term interest rates (yields on 10-year Treasury bonds) in the euro-zone marked 3.10%, down 58 basis points over the same period.

Short-term market interest rates maintained an upward trend in the US owing to the continued increase of the policy rate. The Federal Reserve increased its target Federal Funds rate on 10 occasions from June 30, 2004 until August 9, 2005, by 25 basis points each time (1% → 3.5%). Japanese and euro-zone short term market interest rates showed no marked changes owing to the continuance in place of the existing accommodative monetary policy stance.

Turning to share prices in major countries, while those in the US continued to fluctuate around the same level as at the end of the previous year, those in Japan and the euro-zone showed a generally upward trend. US share prices fell back sharply in March and April on heightened worries of the economy hitting a soft patch

**<Figure Ⅰ- 4>**

**Stock Price Indices[1] in Major Economies**




Note: 1) Based on spot market price.
Source: Bloomberg.

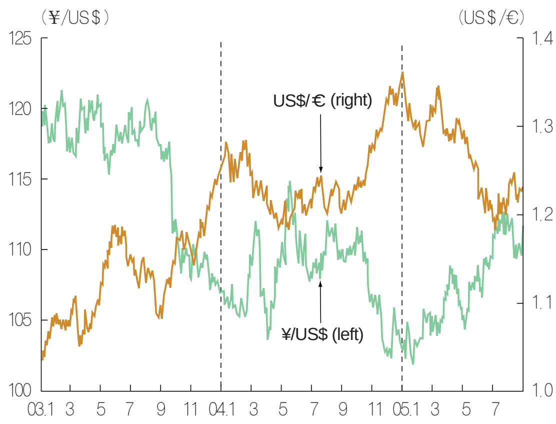
owing to the sharp run-up in oil prices and the prospect of the Federal Reserve's continued policy rate hike to counter inflation pressures. From early May, as fears of a business downturn reduced, share prices rebounded and they continued to show a smooth upward trend through July. From early August they staged a downward correction because of the steep run-up in oil prices. As of the end of August, the Dow Jones Industrial Average Index was down 2.8% compared with the end of the previous year and the NASDAQ index was down 1.1%.

Japanese share prices showed an upward trend early in the year as anticipations of a recovery of domestic demand became widespread, but they fell back sharply in April owing to the weakened performance of some firms and concerns over the shrinking of China-Japan trade. However, they shifted to a relatively steep upward trend helped by improved domestic demand indices and hopes of export growth fuelled by the weakness of the Japanese yen. As of the end of August, the Nikkei Index had put on 8% compared to the previous year-end. Apart from short-lived downward trend during April amid mounting concern over the delay in business recovery, euro-zone share prices maintained a generally upward trend owing to the euro's weakness and expectations of an upswing in corporate performance. As of the end of August the Euro Stoxx Index had risen 10.6% compared with the end of December 2004.

In early 2005 the US dollar shed its weak trend evident since the previous October but shifted to a clearly-marked strengthening trend against the yen and the euro. For a while in March, the US dollar showed a softer tendency against the euro under the influence of the widened US current account deficit. Subsequently, it generally maintained a firm trend owing to the

<Figure Ⅰ- 5>

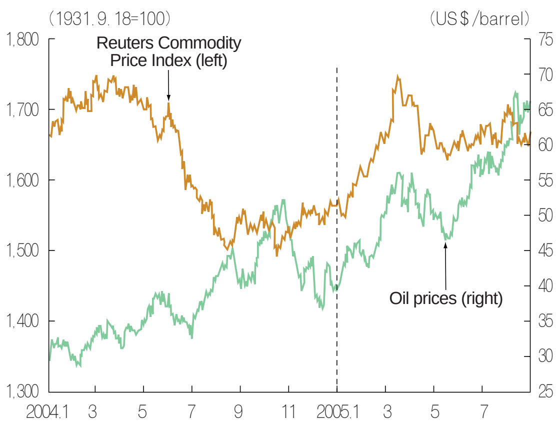
**Major Exchange Rates[1]**




Note: 1) US$/€ on New York market, ¥/US$ on Tokyo market.
Source: Bloomberg.

<Figure Ⅰ- 6>

**International Raw Material Prices[1]**




Note: 1) International oil prices are based on the price of Brent Crude.
Source: Reuters.

widening difference between US and euro-zone growth and interest rates, and worries over delay in European integration following the rejection of the proposed new European Union constitution by voters in France and the Netherlands. Accordingly, the US dollar had appreciated 9.8% against the euro from 1.36 dollars per euro at the end of the previous year, to 1.23 dollars per euro by the end of August. Despite anticipations of the Chinese yuan's revaluation, the US dollar maintained its firm trend against the Japanese yen in reflection of the relative buoyancy of US business activity and the shrinking of the Japanese current account surplus. This brought the US dollar to the level of 111.7 yen per dollar by the end of August, which represented an appreciation of 9% over the end of the previous year.

On July 21, the People's Bank of China changed the foreign exchange regime to one based on market supply and demand with reference to a basket of currencies, and adjusted the exchange rate of the yuan from 8.28 per dollar to 8.11 per dollar.

## C. International Raw Material Prices

International oil prices continued to move steeply upward from early 2005 owing to the heightened mismatch between supply and demand and the inflow of speculative funds. After repeatedly touching new historic highs, the price of Brent crude reached 56.3 dollars a barrel on March 17, but then oil prices showed a downward pattern for a while owing to worries over the stalling out of world economic growth and an increase in US stocks of crude oil. However, they returned to a steeply rising trend in early June in response to the combination of more widespread prospects of a continuing increase in world oil demand, a reduction in OPEC's spare production capacity, the heightened geopolitical uncertainties surrounding producing countries and a shortage of refining capacity. They went on climbing to reach a new high of 67.26 dollars per barrel on August 12.

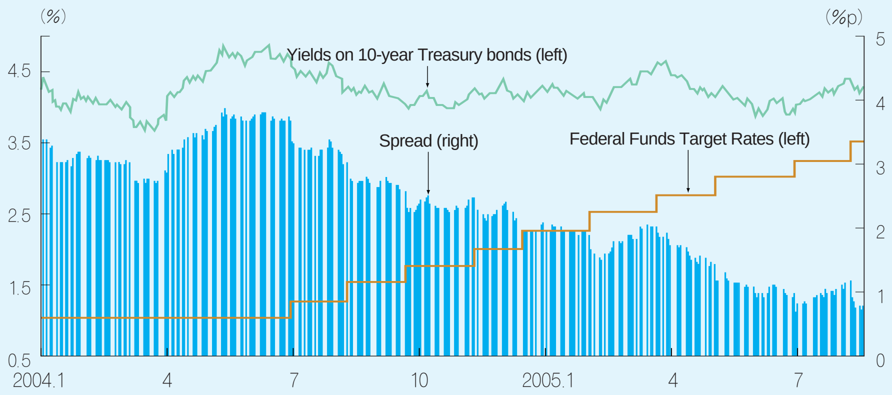
The prices of international raw materials apart from crude oil also showed a sharp upward trend during the first quarter, fuelled by the increased demand resulting from China's rapid growth. After falling back from early April on concerns over a global slowdown of business activity, they maintained a largely stable pattern. Nonferrous metals continued a generally upward trend while cereal prices rose by a large margin in late April amid concerns over poor harvests, but they subsequently shifted back to a stable trend. As a consequence, the Reuters Commodity Price Index registered 1,672.5 as of the end of August, a 6.5% rise compared to the end of 2004.

<Box Ⅰ-1>

## Major Reasons for the Conundrum of US Long-term Interest Rates

Even though the US Federal Reserve repeatedly raised its Federal Funds Target Rate (1%→ 3.5%) from June 2004 onwards, US long-term interest rates (yields on 10-year Treasury bonds) eased slightly or remained at low levels, so that the spread between long-term and short-term interest rates narrowed greatly. Alan Greenspan, Chairman of the Federal Reserve, termed this phenomenon a conundrum for which there was little precedent.

**US Long- and Short-term Interest Rates**




Source : Bloomberg.

While a lively debate has broken out among economic pundits over the causes of these movements of long-term interest rates, the principal contributory factors involved may be analysed as follows.

Firstly, foreign investors such as the central banks of Asian countries, have greatly expanded their purchases of long-term US Treasury bonds. Foreign investors' share of US 10-year Treasury bonds outstanding rose from 42.7% at the end of 2003 to 47.6% at the end of 2004 and to 49.6% at the end of June 2005. This is mainly because the funds accumulated from the large-scale current account surpluses of Asian countries and firms' net savings have been largely invested in US long-term Treasury bonds, which combine a high degree of stability with liquidity. At the same time, concerns over the cooling of the global economy because of higher oil prices and investors' intensified flight to quality following the GM bond debacle stimulated additional demand for US Treasury bonds.

**US Long-term Treasury Bond Issues**

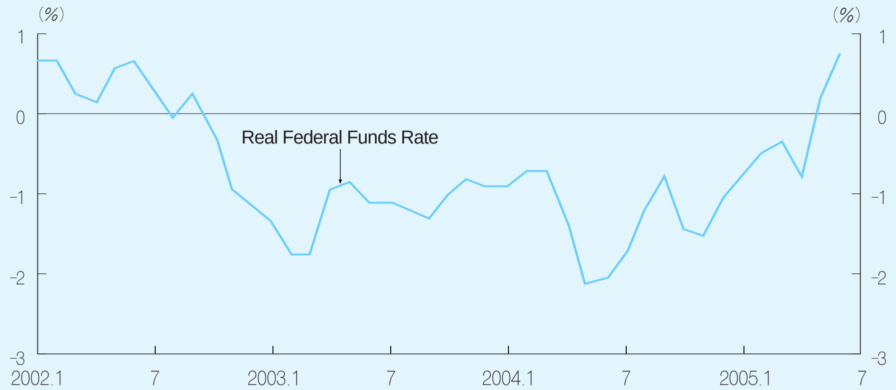
(billion dollar, %)

| | 2003 | 2004 | | | | | 2005 | | |
|---|---|---|---|---|---|---|---|---|---|
| | | Ⅰ | Ⅱ | Ⅲ | Ⅳ | Year | Ⅰ | Ⅱ | 1st half |
| Net Issue of US Treasury bonds[1] | 369.9 | 146.0 | 34.3 | 90.6 | 113.7 | 384.6 | 144.1 | -72.7 | 71.3 |
| Foreign holdings[2] | 289.2 | 142.2 | 101.7 | 59.1 | 54.1 | 357.1 | 92.6 | 22.2 | 114.8 |
| Share of foreign holdings[3] | 42.7 | 44.9 | 47.2 | 47.6 | 47.6 | 47.6 | 48.2 | 49.6 | 49.6 |

Notes: 1) Based on marketable Long-term Treasury Bonds (10-year).
2) Increased amount.
3) Foreign holdings/outstanding amounts on a year-end basis.
Source: The US Treasury.

Secondly, despite the Federal Reserve's continued ratcheting-up of interest rates, the real Federal Funds rate has continued to be negative. In view of the fact that, they did not return into positive territory until recently, the stance of US monetary policy might be assessed as still being accommodative.

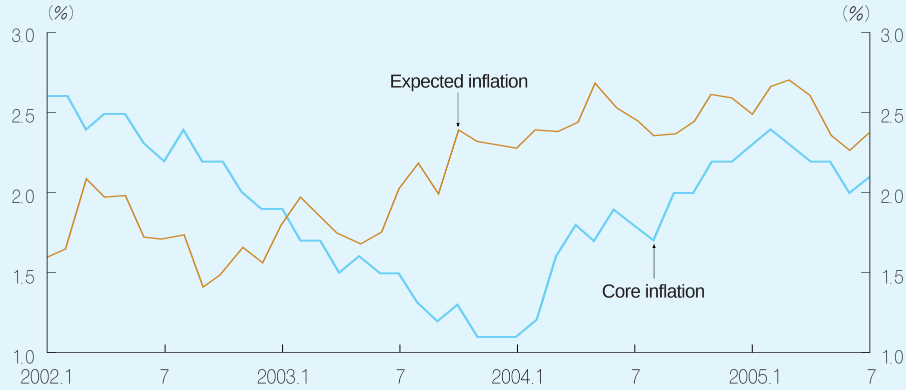
**Real Federal Funds Rate[1)]**




Note: 1) Federal Funds Rate - Consumer Price Inflation.
Source : Bloomberg.

Thirdly, despite high oil prices, both core inflation and inflation anticipations (yields on 10-year Treasury bonds - yields on inflation linked 10-year Treasury bonds) have presented stable trends. This has served as a factor limiting the upward movement of long-term interest rates. Bond market participants have taken the view that there would be no great likelihood of increased inflation pressures in future owing to the Federal Reserve's continued ratcheting-up of interest rates.

**Core Inflation and Expected Inflation[1)] in the US**




Note: 1) Yields on 10-year Treasury bonds - yields on inflation linked 10-year Treasury bonds.
Source: Bloomberg.

Fourthly, because of the measured pace of the Federal Reserve's upward adjustment of the policy interest rate over a prolonged period of time and its consequent predictability, risk premiums on bond investment have narrowed. Through speeches by senior members of the Federal Reserve Board and the statements of the Federal Open Market Committee, the Fed has consistently communicated its planned progressive interest rate adjustment and, in consequence, it has been assessed that the uncertainty concerning the future direction of monetary policy would evaporate.

Finally, although the US economy has been currently maintaining a convincing growth performance, the risk of a cooling of growth in response to the sharp run-up in oil prices should be by no means trifling. Consequently, these concerns, it is claimed, have been incorporated into the formation of long-term market interest rates.

# 2. Domestic Economy

## A. Economic Growth

While the real economy continued on its low growth path during the first half of the year, it showed gradual stirrings of improvement. During the first half of the year, the GDP growth rate dropped to 3.0% year-on-year as against its 3.9% in the latter half of last year. Seen by period, first-quarter growth stood at 2.7% year-on-year and second-quarter growth at 3.3%. On a seasonally adjusted basis compared to the preceding quarter, the GDP growth rate marked 0.4% in the first quarter and 1.2% in the second quarter.

**<Table Ⅰ- 3>**

**Major Economic Growth Indicators[1)]**

(%)

| | 2003 | 2004[p] | | | | | 2005[p] | | |
|---|---|---|---|---|---|---|---|---|---|
| | | Year | 1st half | 2nd half | Ⅲ | Ⅳ | 1st half | Ⅰ | Ⅱ |
| GDP[2)] | 3.1 | 4.6 | 5.4 | 3.9 | 4.7 (0.8) | 3.3 (0.9) | 3.0 | 2.7 (0.4) | 3.3 (1.2) |
| (Private consumption) | -1.2 | -0.5 | -0.9 | -0.1 | -0.8 | 0.6 | 2.1 | 1.4 | 2.8 |
| (Facilities investment) | -1.2 | 3.8 | 3.0 | 4.6 | 6.8 | 2.5 | 3.0 | 3.1 | 2.9 |
| (Construction investment) | 7.9 | 1.1 | 4.1 | -1.3 | 1.3 | -3.4 | -0.2 | -2.9 | 1.7 |
| (Goods export) | 18.5 | 21.0 | 29.2 | 14.0 | 18.0 | 10.5 | 7.3 | 8.1 | 6.5 |
| (Goods import) | 11.4 | 13.8 | 17.4 | 10.5 | 12.5 | 8.8 | 3.4 | 3.1 | 3.6 |
| GNI | 1.9 | 3.8 | 4.7 | 2.9 | 3.6 | 2.3 | 0.2 | 0.5 | 0.0 |

Notes: 1) Compared with the same period of the previous year.
2) Figures in parentheses refer to the seasonally-adjusted rates of increase compared with the previous period.

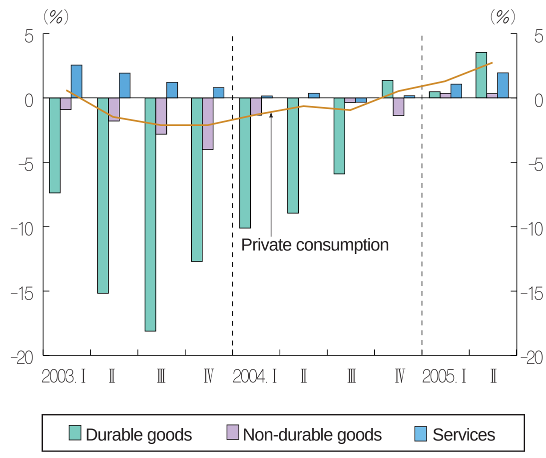
During the first half of the year, real gross national income registered only a 0.2% rise over the same period of the previous year owing to the weakening of the terms of trade brought about by the sharp run-up in international oil prices and a fall in semiconductor prices. In consequence, the gap between the first-half GDP growth rate and the rate of increase in the GNI widened greatly from its 1.0 percentage point of the second half of the previous year to 2.8 percentage points.

### (Demand)

Looking at the individual components of demand, during the year to June private consumption expenditures carried on their modest recovery trend from the fourth quarter of the previous year. Exports exhibited a constant increase, but no clear improvement in facilities investment emerged and construction investment presented a lackluster picture.

**<Figure Ⅰ- 7>**

**Major Consumption Indicators[1)]**

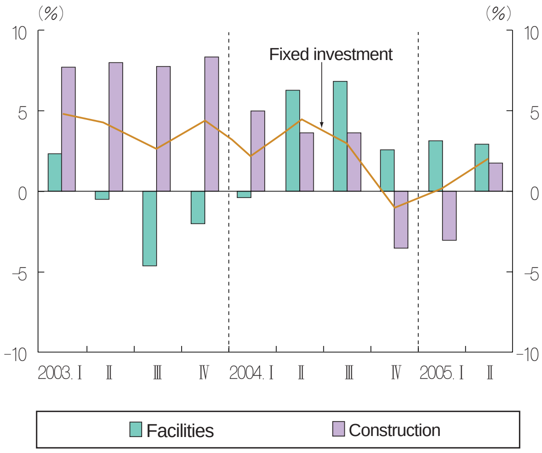



Note: 1) Compared with the same period of the previous year.

Private consumption saw its recovery trend at a feeble pace during the first quarter in spite of the improvement in consumer sentiment indices brought about by the rise in share prices at the beginning of the year. From early April onwards, however, its pace picked up somewhat to bring the first-half growth of private consumption to 2.1% year-on-year. By type of spending there was an increase of 2.0% in spending on durables that was led by computers and peripherals while that on non-durables rose 0.3%, after having declined until the fourth quarter last year. The consumption of services increased 1.5%, centering on entertainment, leisure, and culture-related spending.

**<Figure Ⅰ- 8>**

**Major Investment Indicators[1)]**




Note: 1) Compared with the same period of the previous year.

Facilities investment remained at the level of 3.0% growth year-on-year during the first half, as an increase of investment in machinery such as precision instruments, electric and electronic devices was counteracted by the effects of lackluster transport equipment investment. Although there was increased investment in infrastructure such as facilities related to transport, electric power generation and communications, non-building construction investment shrank sharply. Consequently, in the first half of the year construction investment as a whole declined by 0.2% year-on-year. By quarter, it shrank 2.9% during the first quarter, but shifted to a rise of 1.7% in the second quarter thanks to the expansion of housing construction investment.

**<Figure Ⅰ- 9>**

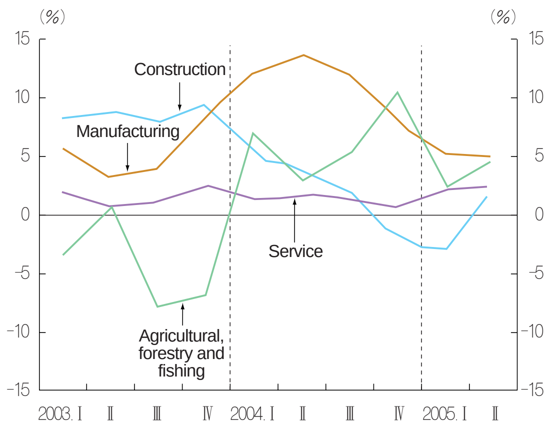
**Export and Import Growth[1)]**


Note: 1) Compared with the same period of the previous year.
Volume basis.

Exports (goods) increased steadily centering on those of semiconductors, automobiles and mobile phones. Their year-on-year rate of growth, however, fell from 14.0% in the latter half of the previous year to 7.3%, blunted by the influence of a base-period effect from their sharp rise in the same period of the previous year. Imports (goods) also rose, led by those of computers and office equipment, but those of petroleum products

**<Figure Ⅰ- 10>**

**Growth[1] by Major Industries**




Note: 1) Compared with the same period of the previous year.

**<Table Ⅰ- 4>**

**Average Capacity Utilization Ratio in Manufacturing Sector**

(%)

| 2001 | 2002 | 2003 | 2004 Year | 2004 1st half | 2004 2nd half | 2005 1st half |
|---|---|---|---|---|---|---|
| 75.3 | 78.4 | 78.3 | 80.3 | 80.9 | 79.8 | 79.5 |

Source: Korea National Statistical Office.

and coal shrank. Consequently their year-on-year rate of increase decelerated sharply from 10.5% in the latter half of 2004 to stand at 3.4%.

### (Production Activities)

Manufacturing and the agricultural and fishing sector both saw their rates of growth fall in the first half of the year, and construction presented a subdued pattern. Meanwhile, services showed a smooth recovery trend.

In manufacturing, the declining trend in light- industry production was maintained while heavy and chemical industry production saw its rate of increase reduced by a base-period effect brought about by its rapid pace in the same period of the preceding year. Consequently the rate of manufacturing production growth year-on-year slowed from the 9.9% of the latter half of the previous year to 5.2%. The average capacity utilization rate in manufacturing, meanwhile, marked the almost same level of 79.5% as in the preceding six-month period.

In the majority of service sectors, including communications, and financial, insurance, real estate and business services, the level of business activity picked up. For the six-month period, the rate of service sector growth rose to 2.4% year-on-year as against just 1% in the latter half of the preceding year. In construction, civil engineering and building construction for housing use both posted an increase, but the construction of buildings for non-housing use contracted so that the sector as a whole declined 0.2% year-on-year, presenting a lackluster picture. Electricity gas and water displayed a comparatively strong growth trend, boosted by the increased consumption of electricity.

<Table Ⅰ-5>

**Major Employment-related Indicators**

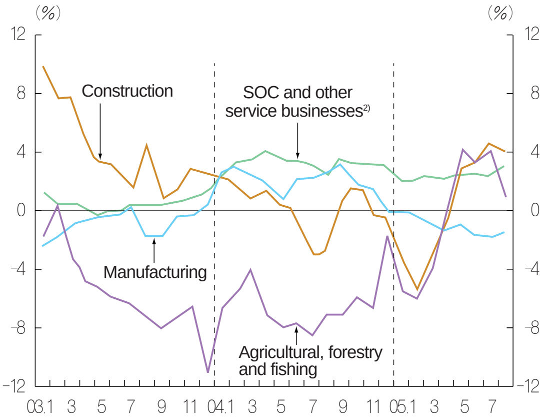
(million, %)

| | 2004 | | | 2005 | | | |
|---|---|---|---|---|---|---|---|
| | Year | 1st half | 2nd half | 1st half | Ⅰ | Ⅱ | Jul.~Aug. |
| Economically active population | 23.4 | 23.3 | 23.5 | 23.6 | 23.2 | 24.0 | 23.9 |
| (rate of growth)[1] | 2.0 | 2.3 | 1.7 | 1.3 | 0.8 | 1.8 | 2.0 |
| Economic participation rate | 62.1 | 61.9 | 62.2 | 61.9 | 61.1 | 62.7 | 62.2 |
| Number of persons employed (S.A.) | 22.6 | 22.6 | 22.6 | 22.8 | 22.7 | 22.9 | 22.9 |
| (rate of growth)[1] | 1.9 | 2.1 | 1.7 | 1.2 | 0.6 | 1.7 | 2.0 |
| Number of persons unemployed | 0.86 | 0.88 | 0.84 | 0.93 | 0.97 | 0.88 | 0.87 |
| (S.A.) | 0.86 | 0.84 | 0.88 | 0.88 | 0.88 | 0.89 | 0.89 |
| Unemployment rate | 3.7 | 3.8 | 3.6 | 3.9 | 4.2 | 3.7 | 3.6 |
| (S.A.) | 3.7 | 3.6 | 3.8 | 3.7 | 3.7 | 3.7 | 3.8 |

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

<Figure Ⅰ-11>

**Growth[1] in the Number of Persons Employed by Industry**




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

<Table Ⅰ-6>

**Employed Persons Ratio[1] by Employment Status**

(%)

| | 2003 | | | 2004 | | | 2005 | |
|---|---|---|---|---|---|---|---|---|
| | Year | 1st half | 2nd half | Year | 1st half | 2nd half | 1st half | Jul.~Aug. |
| Regular | 50.5 | 50.3 | 50.6 | 51.2 | 50.8 | 51.5 | 52.1 | 52.1 |
| Temporary | 34.7 | 34.8 | 34.7 | 34.1 | 34.7 | 33.6 | 33.4 | 33.1 |
| Daily | 14.8 | 14.9 | 14.7 | 14.7 | 14.5 | 14.9 | 14.5 | 14.7 |

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

## B. Employment and Wages

### (Employment)

During the first eight months of 2005, the seasonally-adjusted unemployment rate remained at a level of 3.7~3.8%, similar to that in the latter half of the preceding year. The number of people in employment increased only 0.6% year-on-year in the first quarter, but grew strongly again from May onwards by around 2% so that employment conditions showed evidence of a certain improvement.

Looking at the figures by industry, in the case of the agricultural, forestry and fishing sector, and the construction sector, the declining trend in the number of persons employed continued on through the first quarter of the year, but after this it shifted to an increasing trend. The number of persons employed in the service sector continued to show a steady upward trend, helped by the improvement in service sector activity. On the other hand, the number of persons employed in the manufacturing sector continued to shrink in the early part of 2005, following on the flattening-out of the upward trend from the fourth quarter of 2004.

During the first half of 2005, the ratio of persons in regular full-time waged employment among all persons in employment stood at 52.1%, which represented a slight improvement over the preceding six-month period.

### (Wages)

Over the first half of 2005, nominal wages (on the basis of businesses employing at least five workers) rose by 7.4% , showing a similar level of increase to that of the

<Table Ⅰ-7>

**Wage Increases[1]**

(%)

| | 2003 | | | 2004 | | |
|---|---|---|---|---|---|---|
| | Year | 1st half | 2nd half | Year | Ⅰ | Ⅱ |
| Nominal wage | 6.0 | 4.4 | 7.5 | 7.4 | 7.5 | 7.4 |
| Real wage | 2.3 | 1.0 | 3.5 | 4.2 | 4.2 | 4.3 |

Note: 1) Compared with the same period of the previous year.
Source: Ministry of Labor.

<Table Ⅰ-8>

**Balance of Payments**

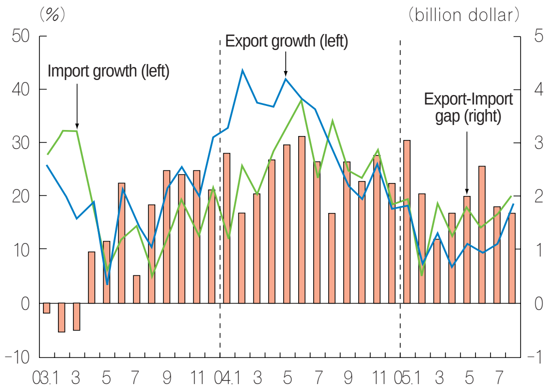
(billion dollar)

| | 2004p | | | 2005p | |
|---|---|---|---|---|---|
| | Year | 1st half | 2nd half | 1st half | Jul. |
| Current account | 27.6 | 13.2 | 14.5 | 8.7 | 1.4 |
| Goods | 38.2 | 19.1 | 19.1 | 17.9 | 3.1 |
| Exports[1] | 253.8 | 123.3 | 130.6 | 136.6 | 23.3 |
| Imports[1] | 224.5 | 108.1 | 116.4 | 124.1 | 21.5 |
| Services | -8.8 | -3.5 | -5.3 | -6.1 | -1.5 |
| Credits | 41.4 | 19.4 | 22.1 | 22.0 | 3.5 |
| Debits | 50.2 | 22.8 | 27.4 | 28.1 | 5.0 |
| Income | 0.7 | -1.0 | 1.7 | -1.9 | -0.1 |
| Current transfers | -2.5 | -1.5 | -1.0 | -1.2 | -0.2 |
| Capital account | 8.3 | 0.8 | 7.5 | 4.7 | -0.8 |
| Financial account | 10.1 | 1.6 | 8.5 | 5.9 | -0.6 |
| Direct investment | 3.4 | 2.2 | 1.2 | 0.5 | -0.5 |
| Portfolio investment | 9.3 | 10.3 | -1.1 | -3.7 | 2.8 |
| Other investment | -2.6 | -10.9 | 8.3 | 9.1 | -2.8 |
| Other capital account | -1.8 | -0.9 | -0.9 | -1.2 | -0.2 |
| Increase(-) in reserve assets | -38.7 | -12.8 | -26.0 | -12.3 | -0.9 |
| Errors and omissions | 2.8 | -1.2 | 4.0 | -1.0 | 0.3 |

Note : 1) Customs clearance basis.

<Figure Ⅰ-12>

**Export & Import Growth[1] and Export-Import Gap**




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

same period a year earlier. Deflating nominal wages by the consumer price index, real wages marked a rise of 4.2%, which was slightly higher than the same period a year before.

## C. External Transactions

### (Current Account)

In 2005 the current account maintained its underlying surplus that was dominated by the large favorable balance on the goods account. For the year to July, however, the scale of the surplus shrank from the 16.4 billion dollars for the same seven-month period a year earlier to 10.1 billion dollars.

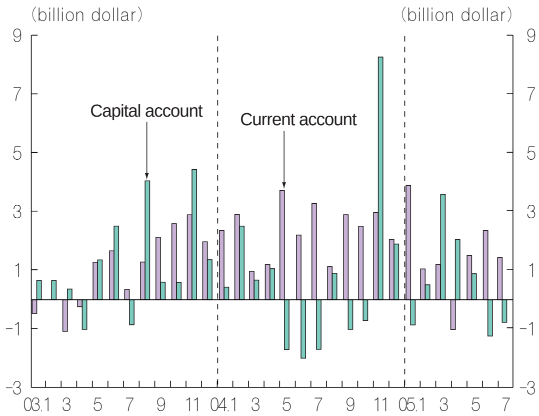
Viewed by component account, the goods account registered a surplus of 21.1 billion dollars during the first seven months of the year thanks to constantly swelling exports. Even so, the scale of its surplus narrowed from that of the same period a year earlier. The service account chalked up a widened deficit of 7.6 billion dollars for the year to July, owing to the expansion of payments for overseas travel and for patents and royalties. The income account accumulated a deficit of 1.9 billion dollars , swollen by the repatriation of dividends, and the current transfers account was in the red to the tune of 1.4 billion dollars.

For the first eight months of the year, exports (customs clearance basis) registered a year-on-year rise of 11.8% to stand at 183.4 billion dollars. By commodity group, light industry products presented a lackluster pattern that centered particularly on textiles, but petroleum products, iron and steel products and petrochemicals all maintained strong rates of growth, and automobiles and semiconductors showed a consistent increase. Imports (customs clearance basis) for the year to August rose 15.8% year-on-year to stand at 167.4 billion dollars. By category, raw materials imports maintained their rapidly increasing trend, driven by higher oil prices, while capital goods and consumer goods imports both continued to build up steadily.

**(Capital Account)**

<Figure Ⅰ- 13>

**Current and Capital Accounts**




For the year to July, the capital account saw a shift from a deficit of 0.9 billion dollars in the same seven month-period of the previous year to a surplus of 3.9 billion dollars.

By component account, the scale of the direct investment account surplus shrank from 1.66 billion dollars for the same seven-month periods a year earlier to 1.5 million dollars. The portfolio investment account registered a deficit of 0.9 billion dollars for the first seven months of the year as domestic residents expanded their overseas securities investment while that of non-residents fell sharply centering on the share markets. In contrast, the other investment account showed a surplus of 6.2 billion dollars due to domestic banks' increased short-term foreign borrowings.

# 3. Financial Markets

## A. Interest Rates and Share Prices

### (Long-term Market Interest Rates)

With the beginning of the year 2005, long-term market interest rates broke free of the previous year's downward trend to move to a rising path. Secondary market yields on 3-year Treasury bonds rose sharply from their 3.28% at the end of December 2004 to reach 4.46% on February 11. This was ascribable to weakening anticipations of further downward adjustment of the call rate target as market expectations of economic recovery grew, and to increased worries over the weakening interplay of bond supply and demand following the announcement of the government's plan to expand the issue of Treasury bonds. But from mid- February onwards, amid mounting concerns over the protracted delay of business recovery, long-term market interest rates shifted to a downward trend that brought secondary market yields on 3-year Treasury bonds down to 3.61% by June 2. Subsequently, long-term market interest rates shifted back to a sharply upward path influenced by anticipations of economic recovery and the possibility of the call rate target being hiked to counter the run-up in real estate prices. Three-year Treasury bond yields, for instance, stood at 4.16% as of the end of August, an 88 basis points' rise since the end of the previous year.

<Table Ⅰ- 9>

**Major Market Interest Rates[1)]**

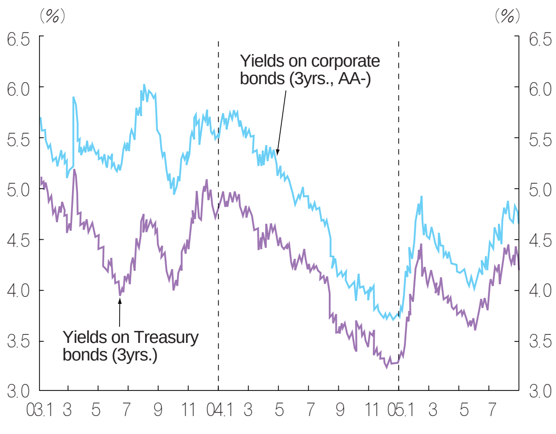
(%)

| | 2003 | 2004 | | 2005 | | | |
|---|---|---|---|---|---|---|---|
| | | Jun. | Dec. | Mar. | Jun. | Jul. | Aug. |
| Call (overnight) | 3.95 | 3.78 | 3.29 | 3.26 | 3.29 | 3.27 | 3.24 |
| CD (91 days) | 4.36 | 3.93 | 3.43 | 3.54 | 3.54 | 3.49 | 3.51 |
| CP (91 days, A1) | 4.55 | 4.02 | 3.61 | 3.73 | 3.66 | 3.62 | 3.63 |
| Treasury bonds (3yrs.) | 4.82 | 4.24 | 3.28 | 3.91 | 4.02 | 4.23 | 4.16 |
| Corporate bonds (3yrs., AA-) | 5.58 | 4.84 | 3.72 | 4.34 | 4.41 | 4.63 | 4.59 |

Note: 1) Period-end basis.
Source: Koscom Corp.

<Figure Ⅰ- 14>

**Major Long-term Market Interest Rates**



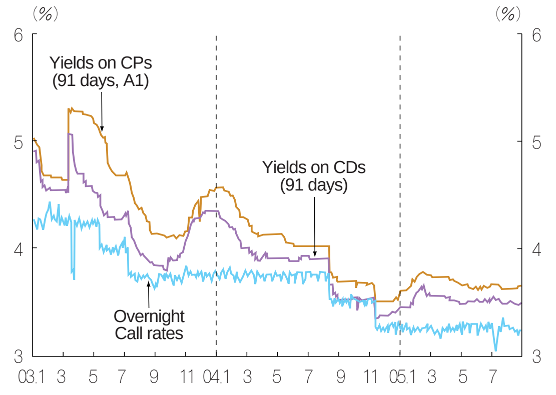

Source: Koscom Corp.

### (Short-term Market Interest Rates)

Short-term market interest rates staged a slight rise at the beginning of the year in sympathy with the steeper run-up in long-term market rates, but otherwise they

**<Figure Ⅰ-15>**

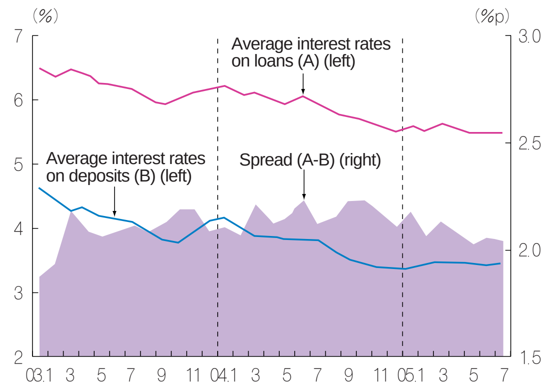
**Major Short-term Market Interest Rates**




Source: Koscom Corp.

**<Figure Ⅰ-16>**

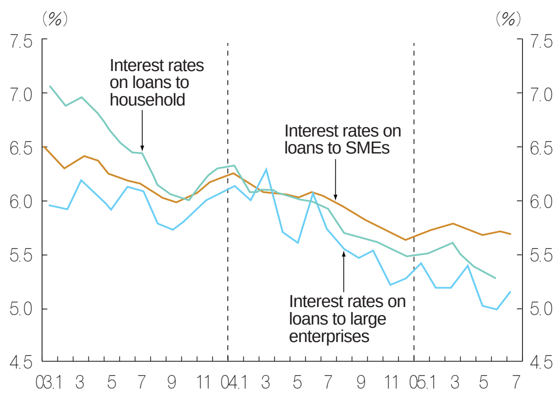
**Interest Rates[1] on Bank Deposits and Loans, and Deposit-Loan Spread**




Note: 1) Based on newly extended loans and deposits.

**<Figure Ⅰ-17>**

**Average Interest Rates[1] on Bank Loans by Borrower**




Note: 1) Based on newly-extended loans.

continued on a largely stable path with the call rate target being held at its existing level. Secondary market yields on 91-day CDs rose by 20 basis points from the 3.43% in of the previous year end to reach 3.63% by February 11, but they subsequently slipped back to mark time at around the 3.5% level. As of the end of August, secondary market yields on 91-day CDs stood at 3.51%, 8 basis points higher than at the previous year end.

**(Financial Institutions' Deposit and Lending Rates)**

Financial institutions' interest rates on deposits and loans exhibited a generally stable trend. Banks' average lending rate (newly-extended amount basis) initially edged up a little from the 5.52% of December 2004 to 5.63% in March, but subsequently eased back to 5.51% in July, a similar level to that of the previous year end. In contrast, banks' average interest rate paid on deposits rose a little from its 3.41% in December 2004 to 3.47% in July 2005, owing to competition among banks in applying preferential rates. Accordingly banks' deposit-loan spread narrowed slightly from 2.11 percentage points in December 2004 to 2.04 percentage points in July 2005.

Looking at rates applied by type of borrower, those to large enterprises fell substantially compared to the end of the previous year, reflecting their lackluster demand for funds. Those to households maintained a downward trend that was led by rates on housing finance loans, but those to small and medium enterprises were held at the same level as the previous year end (average rate of 5.72% during January ~ July), owing to banks' conservative credit extension policy.

**<Table Ⅰ-10>**

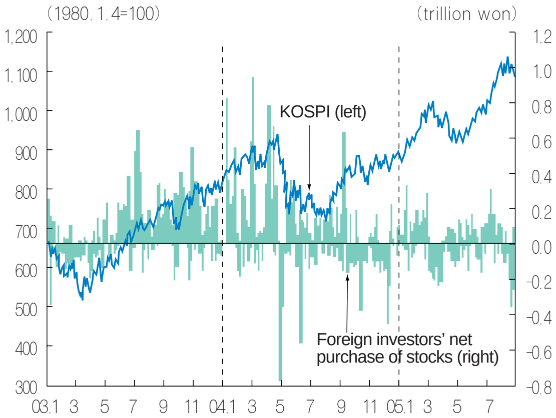
**Stock Market Indicators**

| | 2003 | 2004 | | 2005 | | |
|---|---|---|---|---|---|---|
| | | 1st half | 2nd half | 1st half | Jul. | Aug. |
| KOSPI[1] | 810.7 (29.2) | 785.8 (-3.1) | 895.9 (10.5) | 1,008.2 (12.5) | 1,111.3 (24.0) | 1,083.3 (20.9) |
| Volume (million shares)[2] | 542 | 421 | 328 | 439 | 649 | 439 |
| Value (billion won)[2] | 2,217 | 2,557 | 1,925 | 2,459 | 3,431 | 3,063 |
| KOSDAQ index[1] | 448.7 (1.1) | 385.2 (-14.2) | 380.3 (-15.2) | 503.2 (32.3) | 546.7 (43.8) | 504.0 (32.5) |
| Volume (million shares)[2] | 408 | 330 | 247 | 527 | 714 | 591 |
| Value (billion won)[2] | 1,079 | 761 | 498 | 1,450 | 1,975 | 1,652 |

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

**<Figure Ⅰ-18>**

**KOSPI and Foreign Investors' Net Purchase of Stocks**




Source: Koscom Corp.

**(Korea Composite Stock Price Index)**

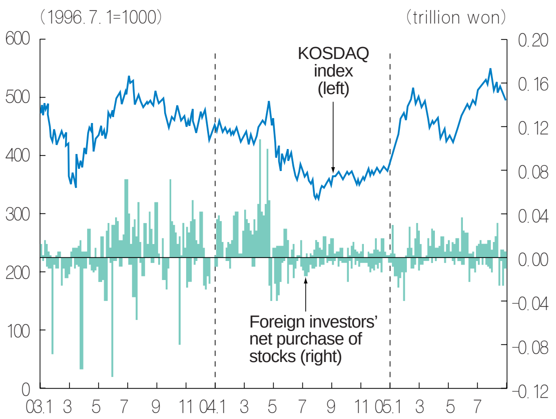
In 2005 to August, the Korea Composite Stock Price Index (KOSPI) moved generally on a sharply upward path driven by anticipations of business recovery and the inflow of long-term investment funds including pension funds and installment type funds.

KOSPI maintained its rising trend evident since August last year, fuelled by the continued inflow of market funds and foreign investors' net buying position, to peak on March 11 at 1,022.8 points. It then embarked on a downward trend amid weakened investor sentiment reflecting oil prices hike and worries over the delayed business recovery. But from early May onwards as optimism over business recovery became widespread, the inflow of long-term investment funds continued and foreign investors returned to a net buying position, it began to rise quickly, recovering within less than four months to break through the 1,000 barrier again on June 15 and climb to 1,100 by July 28. As of the end of August KOSPI stood at 1,083.3, having risen 20.9% since the end of the previous year.

Looking at the trend of share trading by category of investor, foreign investors maintained a net buying trend around the beginning of the year. However, from early March they adopted a net selling position for 20 straight trading days (cumulative net sales of 2.1 trillion won) amid concerns over a weakening IT business situation and profit-taking on the long run-up in share prices. From May onwards , they shifted back to a net buying position, whose scale was greatly expanded from July onwards, but in August they again became net sellers. Domestic institutional investors, after repeatedly alternating between net buying and net selling during the first four months of the year, sustained a net buying position from May onwards that was led by asset management companies and pension funds. In contrast, individual investors were modest net buyers during March and April when share prices were declining, but otherwise they mainly maintained a net selling position.

<Figure Ⅰ-19>

**KOSDAQ Index and Foreign Investors' Net Purchase of Stocks**




Source: Koscom Corp.

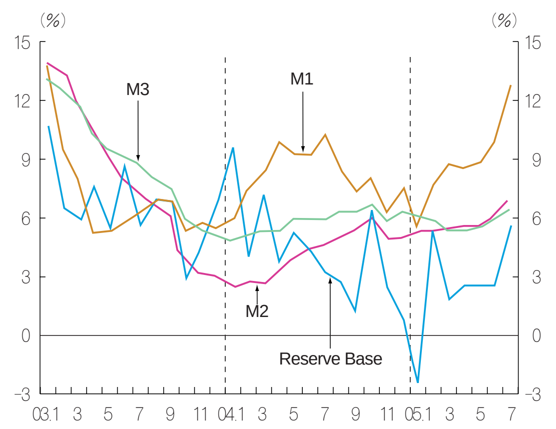
### (KOSDAQ Index)

From early 2005 the KOSDAQ Index showed a more rapid upward trend than the composite share price index, under the impact of the 'Measures to Revitalize the KOSDAQ Market and Venture Business Funding,' unveiled in late 2004. During January the KOSDAQ index rose by 24.4%, much more than KOSPI's 4.1%-increase. Following this, it retained its convincing upward trend, apart from a smooth correction during the months of March and April. It stood at 504.0 as of the end of August, a 32.5% gain over the previous year-end.

## B. Money Supply and Financial Institutions' Deposit

<Figure Ⅰ-20>

**Growth Rate[1] of Major Monetary Aggregates**



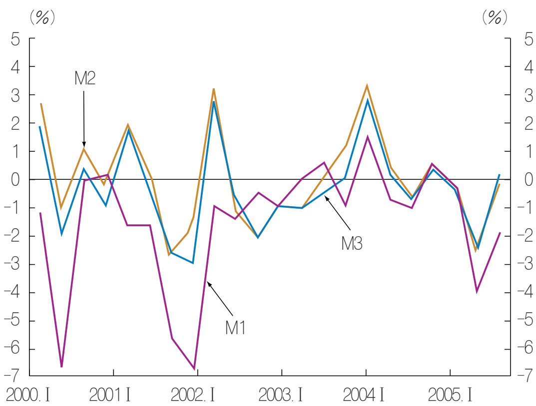

Note: 1) Compared with the same month of the previous year. Based on monthly average.

### (Monetary Aggregates)

The growth rate of M3 on average balance basis held steady at around the 6% level of the previous year in 2005. That of M2 (broad money) marked time at a little above the mid-5 percent level before rising to the 6% level from June onwards. On the other hand, the growth rate of M1 (narrow money), which indicates short-term liquidity, accelerated continually so as to reach 12.8% year-on-year during July in response to heightened transaction demand as business activity picked up and the intensified shortening of the maturities of market funds. Reserve Base remained at a low growth rate in general except when swayed by seasonal factors.

**<Figure Ⅰ- 21>**

**Changes in Money Velocities[1]**




Note: 1) Compared with the same period of the previous year. Based on monthly average.

**<Table Ⅰ- 11>**

**M3 Supply[1] by Sector**

(trillion won)

| | 2003 | 2004 Year | 2004 1st half | 2004 2nd half | 2005 1st half |
|---|---|---|---|---|---|
| Government | 11.2 | 14.8 | 13.1 | 1.6 | 15.5 |
| Public sector | -19.7 | -16.0 | -10.8 | -5.3 | -3.4 |
| Private sector | 60.0 | 41.0 | 19.9 | 21.2 | 38.7 |
| (Loans and discount) | 76.6 | 46.4 | 29.5 | 16.9 | 28.9 |
| (Securities)[2] | -18.1 | -14.8 | -16.4 | 1.6 | 12.0 |
| (Loans in foreign currency)[3] | 2.9 | -0.6 | 1.9 | -2.5 | 3.6 |
| Foreign sector | 31.8 | 25.4 | 18.2 | 7.2 | 4.3[4] |
| Others | -29.3 | 11.3 | 6.1 | 5.2 | -8.4[4] |
| M3 changes | 54.0 | 76.4 | 46.5 | 29.9 | 46.6 |

Notes: 1) Changes based on period-end balance.
2) Corporate bonds, CPs, etc.
3) Foreign currency credits, advanced payment against foreign currency payment guarantees, etc.
4) Before foreign exchange revaluation.

Although money velocity maintained a downward trend that had persisted from the fourth quarter of the previous year, it became much less steep from early in the second quarter onwards as business activity began to pick up seamlessly.

### (Money Supply by Sector)

Looking at the details of M3 money supply by sector during the year to June, there was a large expansion in the scale of money supply through the private and government sectors as compared with the same half of the previous year.

During the first half of 2005, money supply through the private sector almost doubled from the 19.9 trillion won of the same period a year earlier to 38.7 trillion won, as private sector credits swelled greatly led by housing finance loans to households and lending to SMEs. The scale of the government sector's money supply widened somewhat from the same period of the previous year to stand at 15.5 trillion won, owing to the frontloading of fiscal spending in order to underpin the business recovery. On the other hand, money supply through the foreign sector narrowed sharply as against the first half of the previous year to 4.3 trillion won in response to the reduction of both the current account surplus and the inflow of non-residents' share investment funds.

### (Banks' Deposits)

During the year to August 2005, deposit money banks' deposits (bank account) rose by 17.3 trillion won, shifting to a large-scale increase from their decline in the latter half of last year. This increase was fed by the rise in banks' short-term deposit-taking of funds supplied principally through the expansion of private

<Table Ⅰ- 12>

**Deposit-taking[1] by Financial Institutions**

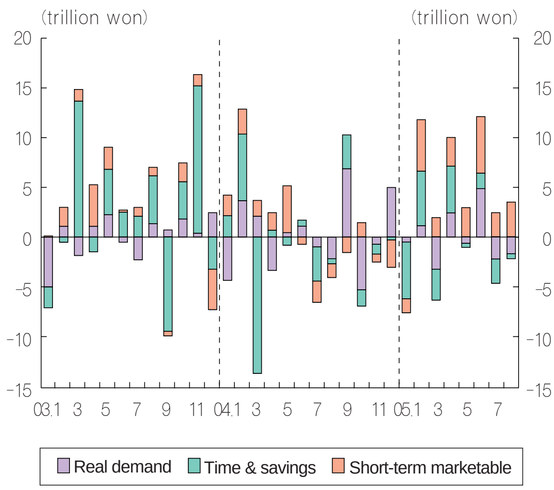
(trillion won)

| | 2003 | 2004 | | | 2005 | | |
|---|---|---|---|---|---|---|---|
| | | Year | 1st half | 2nd half | Ⅰ | Ⅱ | Jul.~Aug. |
| Deposit money banks[2] | 39.9 | -0.6 | 7.2 | -7.8 | -0.1 | 23.7 | -6.3 |
| Real demand | 1.4 | 2.0 | -0.6 | 2.6 | -2.5 | 6.5 | -3.6 |
| Time & savings | 29.3 | -7.4 | -4.0 | -3.4 | -3.2 | 5.8 | -2.7 |
| (Time) | 14.7 | -0.4 | 2.7 | -3.2 | -3.0 | 1.5 | 0.6 |
| (Instant access) | 15.7 | -7.3 | -7.0 | -0.3 | 1.1 | 5.6 | -3.2 |
| CD+RP | 9.3 | 4.7 | 11.6 | -6.9 | 5.9 | 10.8 | 6.2 |
| Cover bills | -0.2 | 0.1 | 0.2 | -0.1 | -0.3 | 0.6 | -0.5 |
| Banks' trust accounts | -15.7 | -9.5 | -5.9 | -3.7 | 1.0 | -1.9 | 1.6 |
| Specific money trusts | -6.7 | -5.0 | -3.9 | -1.1 | 2.3 | -0.4 | 2.7 |
| Asset management companies | -28.6 | 45.2 | 16.0 | 29.2 | 5.3 | 4.7 | 9.2 |
| Short-term bond type | -3.5 | 13.1 | 1.1 | 12.0 | -7.8 | -0.7 | -1.9 |
| Long-term bond type | -3.7 | 8.8 | 2.8 | 6.0 | -2.1 | -0.4 | -2.2 |
| MMFs | -7.2 | 17.7 | 11.5 | 6.2 | 8.9 | 1.2 | 9.6 |
| Stock type | -1.0 | -0.9 | -1.0 | 0.2 | 1.7 | 2.3 | 1.9 |
| Mixed type | -13.1 | -1.4 | 0.8 | -2.2 | 0.8 | -0.5 | 0.2 |

Notes: 1) Based on changes during the period.
2) Includes due from the government and excludes deposits of the Korea Development Bank.
Source: Asset Management Association of Korea.

<Figure Ⅰ- 22>

**Deposits[1] at Banks by Product**




Note: 1) Based on changes during the month.

sector credits and of government expenditures. By type of deposit, short-term marketable deposit products such as CDs and RPs marked an increase of 22.7 trillion won during the first eight months of the year whereas demand deposits saw only a 0.4 trillion won rise. Despite the brisk tone of deposit-taking by instant access account products (+3.5 trillion won), savings deposits slipped by 0.1 trillion won, led downward by a fall in time deposits (-0.9 trillion won).

Banks' trust accounts deposits attracted an additional 0.7 trillion won during the year to August. Although nonspecific money trusts decreased due to withdrawals of maturity funds in line with the cessation of their fresh handling (July 5, 2004), specific money trusts increased a lot thanks to efforts by a number of banks to expand their money-in-trust deposits through a reduction of fees and new product sales.

**(Asset Management Companies' Deposits)**

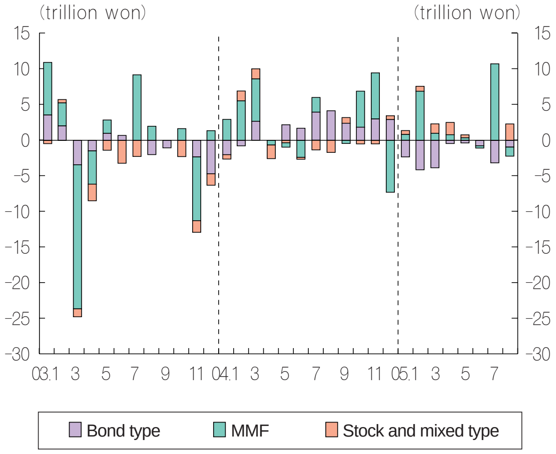
During the year to August, asset management companies' funds outstanding rose by 19.2 trillion won, although the scale of the increase was greatly narrowed from the latter half of last year. This performance represented the net result of a continued large-scale expansion in MMFs as market funds were concentrated at the short-term end of the yield curve and an increase in share-type beneficiary certificates, but a shift to a substantial decrease (-15.1 trillion won during the year to August) in both long and short-term bond type beneficiary certificates amid widening anticipations of higher market interest rates.

## C. Corporate Financing and Household Credits

### (Banks' Corporate Lending)

<Figure Ⅰ- 23>

**Outstanding Amounts[1] of Asset Management Companies by Product**




Note: 1) Based on changes during the month.
Source: Asset Management Association of Korea.

Banks' corporate lending (including trust account loans) rose by 10.2 trillion won during the first eight months of the year. By size of company, bank lending to SMEs saw a large-scale increase of 7.9 trillion won, in contrast to a fall of 4.0 trillion won in the same eight-month period a year earlier. This was mainly brought about by banks' drive to expand their lending, along with the demand for working-capital funds from prime SMEs. In addition, lending to large businesses increased somewhat from the beginning of the second quarter after having retained a listless trend for some time in response to their securing of abundant liquidity from buoyant exports and their subdued demand for facilities investment funds.

### (Direct Financing)

<Table Ⅰ- 13>

**Bank Lending[1] by Sector**

(trillion won)

| | 2003 | 2004 | | | 2005 | | |
|---|---|---|---|---|---|---|---|
| | | Year | 1st half | 2nd half | Ⅰ | Ⅱ | Jul.~Aug. |
| Large enterprises | -4.3 | -3.1 | -1.1 | -2.0 | -0.1 | 0.2 | 2.1 |
| SMEs | 34.8 | 6.9 | 10.9 | -4.0 | 2.6 | 3.9 | 1.4 |
| Total | 30.5 | 3.8 | 9.8 | -6.0 | 2.5 | 4.2 | 3.5 |

Note: 1) Includes trust account loans (except discount of CPs).
Based on changes during the period.

During the year 2005 to August, the scale of firms' fund-raising from the direct financial markets (net increase basis), which had decreased by 1.9 trillion won in the latter half of the preceding year, registered an increase of 5.2 trillion won. This reflected a situation in which, despite rising share prices, fund-raising through the issue of shares contracted whereas the issue of corporate bonds and commercial papers (CPs) broke free of its persistent net redemption trend to register a small-scale net issuance position. The scale of maturing corporate bonds shrank sharply while their issuance for early rollovers and to pay off short-term borrowings was increased by the prospects of an interest rate hike.

<Table Ⅰ- 14>

**Corporate Fund-raising[1] by Direct Financing**

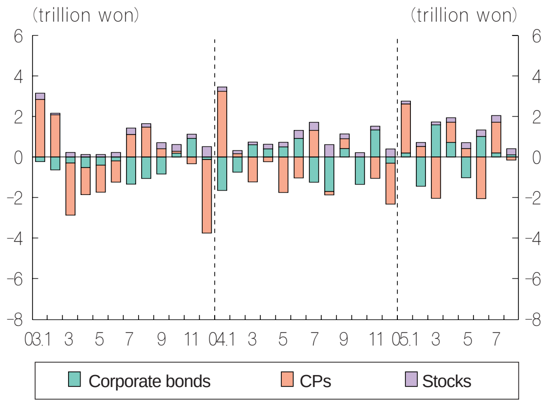
(trillion won)

| | 2003 | 2004 | | | 2005 | | |
|---|---|---|---|---|---|---|---|
| | | Year | 1st half | 2nd half | Ⅰ | Ⅱ | Jul.~Aug. |
| Corporate bond issuance (net)[2] | -4.0 | -2.4 | 0.3 | -2.6 | 0.4 | 0.7 | 0.2 |
| CP issuance (net)[3] | -2.0 | -2.0 | -0.8 | -1.2 | 1.0 | -0.5 | 1.4 |
| Stock issuance[4] | 2.8 | 3.1 | 1.1 | 2.0 | 0.5 | 0.6 | 0.7 |
| Total | -3.3 | -1.3 | 0.6 | -1.9 | 1.9 | 0.9 | 2.4 |

Notes: 1) Based on changes during the period.
2) Excludes those issued by companies under court receivership, and in process of mediation or workout.
3) Based on CP discounts by securities companies, merchant banks and bank trust accounts.
4) Based on companies listed on the Korea Stock Exchange or KOSDAQ, but excludes fund-raising by financial institutions and debt-for-equity swaps by creditor financial institutions for the purpose of structural adjustment of corporations.
Sources: Financial Supervisory Service, Asset Management Association of Korea

<Figure Ⅰ- 24>

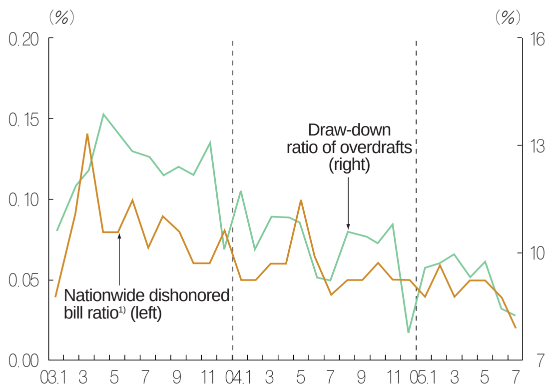
**Corporate Fund-raising[1] by Direct Financing**




Sources : Financial Supervisory Service, Asset Management Association of Korea

<Figure Ⅰ- 25>

**Major Corporate Funding Conditions' Indicators**




Note: 1) After adjustment for electronic settlements.

Accordingly corporate bonds saw net issuance of 1.3 trillion won during the first eight months of the year. CPs registered net issuance of 1.9 trillion won as public sector companies were net issuers although ordinary firms' demand for its issue still remained at a low ebb. The scale of fund-raising through the share market registered 1.8 trillion won.

### (Corporate Funding Conditions)

For the year 2005 to August, with market liquidity generally ample and firms demand for funds slack, no particular problems were experienced in corporate fund-raising conditions except for SMEs with sub-par credit standing.

The ratio of default on bills (after adjustment for electronic settlements) and the draw-down ratio of prearranged overdraft facilities, an indicator of the urgency of firms' demand for funds, both remained at a low level while the number of defaulting companies shrank. The arrears rate on banks' business loans also fell somewhat. On the other hand , because of banks' adherence to their conservative lending stance toward SOHOs and SMEs with low credit standing, such firms still encountered difficult fund-raising conditions.

### (Household Credits)

From early 2005 the rate of increase of household credits gathered further pace compared to the previous year. In the first quarter the scale of the increase was only 3.1 trillion won, but in the second quarter the figure was 16.3 trillion won, totalling 19.3 trillion won for the first half of the year. Specifically, the second quarter saw a much larger scale of increase than in the first quarter. Banks' household credits marked an increase of 11.4 trillion won, centering on housing

<Table Ⅰ- 15>

**Household Credits[1]**

(trillion won)

| | 2004 | | | 2005 | | |
|---|---|---|---|---|---|---|
| | Year | 1st half | 2nd half | Year | Ⅰ | Ⅱ |
| Banks loans | 22.6 | 11.5 | 11.0 | 14.3 | 2.9 | 11.4 |
| Non-bank financial association loans | 5.9 | 1.3 | 4.6 | 5.0 | 0.9 | 4.2 |
| Sales credits | -1.4 | -2.4 | 1.0 | 0.0 | -0.7 | 0.7 |
| Total | 27.1 | 10.4 | 16.6 | 19.3 | 3.1 | 16.3 |

Note: 1) Based on changes during the period.

<Table Ⅰ- 16>

**Major Arrears Rates[1]**

(%)

| | | 2003 | 2004 | | | | 2005 | |
|---|---|---|---|---|---|---|---|---|
| | | | Ⅰ | Ⅱ | Ⅲ | Ⅳ | Ⅰ | Ⅱ |
| Banks | Company loans | 2.4 | 2.5 | 2.7 | 2.4 | 2.5 | 2.3 | 2.4 |
| | Household loans | 2.2 | 2.3 | 2.3 | 2.2 | 2.0 | 2.0 | 1.9 |
| Credit cards companies | Credit card subsidiaries of banks | 11.3 | 10.0 | 10.1 | 8.8 | 7.5 | 5.0 | 4.7 |
| | Credit card specialized companies[2] | 14.1 (28.3) | 12.2 (27.5) | 10.8 (25.1) | 11.6 (23.1) | 9.0 (18.2) | 8.2 (15.7) | 7.6 (13.3) |

Notes: 1) Simple average of monthly overdue ratios (except the end-month in every quarter).
Based on overdue over 1 month.
2) Based on the end of period.
Figures in parentheses include roll-over loans in arrears.
Source: Financial Supervisory Service.

finance loans while credit-union type institutions such as mutual finance companies were able to expand their household credits by 4 trillion won. Purchase credits such as those of credit card companies and installment finance companies shifted to an increase of 0.7 trillion won.

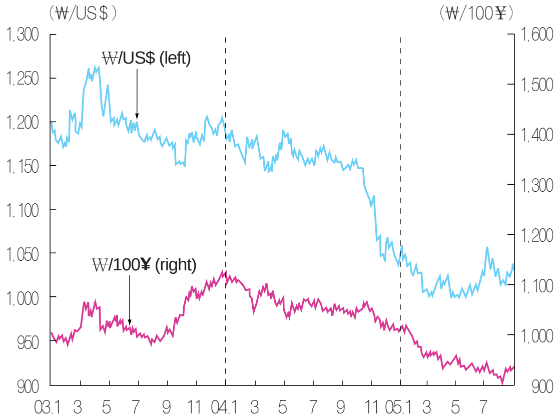
Meanwhile, arrears rates on household credits continued on a declining trend for both banks and credit card companies.

# 4. Foreign Exchange Markets

### (Exchange rates)

<Figure Ⅰ- 26>

**Major Exchange Rates[1]**



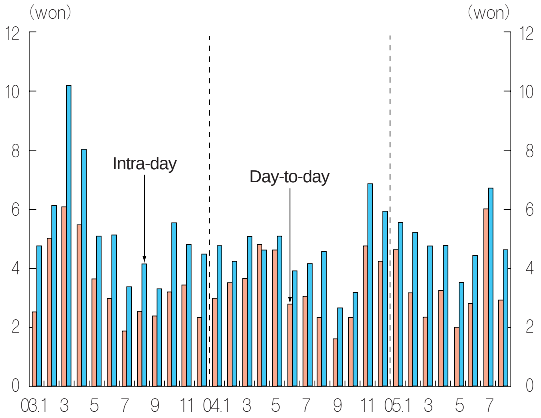

Note : 1) Closing price basis.

The Korean won continued to strengthen against the US dollar in the early months of 2005, maintaining the trend evident since the October of the previous year, and for a while in late April it changed hands at below 1,000 won per dollar. From mid-June onwards, however, the exchange rate fluctuated within a range of 1,010~1,050 won per dollar.

Until early March, the Korean won firmed against the US dollar, reaching the 1,000 won per dollar level as the US dollar's underlying weak tone persisted in global markets. Helped by the US dollar's shift to a strengthening trend based on expectations of the Federal Reserve's continued upward adjustment of interest rates and by the lessening of the preponderance of foreign exchange supply in the interplay of supply and demand in the domestic foreign exchange market, the Korean won traded for a time at around 1,020 won per dollar in mid-April. As a climate of opinion became widespread that a revaluation of the Chinese yuan was at hand, however, the Korean won strengthened to 997.10 won to the dollar on April 29. From mid-June, however, the forces pulling the exchange rate upward and downward were fairly evenly mixed: the US dollar showed a stronger tone in international financial markets, non-residents engaged in large-scale purchases of NDF's, and the Chinese yuan was revalued on July 21, sparking expectations of its further appreciation. Accordingly the exchange rate fluctuated within a range of 1,010~1,050 won per dollar, standing at 1,038.51 won per dollar as of the end of August.

**<Figure Ⅰ- 27>**

**Exchange Rate (₩/US$) Fluctuations**




**<Table Ⅰ- 17>**

**Foreign Reserves[1)]**

(billion won)

| 2003 | 2004 | | | | 2005 | | | |
|---|---|---|---|---|---|---|---|---|
| | Mar. | Jun. | Sept. | Dec. | Mar. | Jun. | Jul. | Aug. |
| 155.4 | 163.6 | 167.0 | 174.5 | 199.1 | 205.5 | 205.0 | 205.7 | 206.7 |

Note : 1) Period-end basis.

Meanwhile the intra-day and day-to-day volatility of the won/dollar exchange rate decreased as the sharply strengthening trend of the Korean won against the US dollar gradually flattened out. The intra-day fluctuation range narrowed from 5.5 won in January to 4.4 won in June and the day-to-day fluctuation range from 4.6 won to 2.8 won over the same period. The exchange rate's volatility increased again from early July onwards, however, in response to the heightened uncertainty concerning the revaluation of the yuan and its impact.

As the movements of the Korean won and the Japanese yen against the US dollar diverged during the early part of the year, with the yen losing ground against the dollar while the Korean won strengthened, the won/yen exchange rate fell below 1,000 won per 100 yen on January 26. Subsequently, the Korean won continued to firm against the yen so that, as of the end of August, it changed hands at 932.7 won per 100 yen, an 8.2% appreciation over the exchange rate at the end of the previous year.

**(Foreign Reserves)**

The country's foreign reserves stood at 206.7 billion dollars as of the end of August, an increase of 7.6 billion dollars over their level at the end of 2004 that reflected the continued current-account surplus and earnings from the operation of the foreign reserves. The scale of the increase of the foreign reserves, however, was much smaller than in the same eight-month period of the previous year (15.1 billion dollars) as a result of US dollar translation losses on euro and yen-denominated assets following the strengthening of the US dollar . Major components of the foreign reserves as of the end of August 2005 were securities holdings valued at 178.3 billion dollars

(86.2%), deposits of 27.7 billion dollars (13.4%) and the country's reserve position with the IMF of 0.6 billion dollars (0.3%).

**(Overseas Borrowing Environment)**

Standard and Poor's, one of the major international credit rating agencies, upgraded Korea's sovereign credit rating by one notch (A- → A) giving a positive assessment to the improved soundness of the financial sector and the heightened flexibility of the exchange rate. At the same time, it maintained the sovereign credit rating outlook as 'stable'. From mid-March onwards, the premium on Foreign Exchange Stabilization Fund Bonds (2013 maturity basis) widened in response to the flight to quality following the downward adjustment of GM's credit rating and the Federal Reserve's continued ratcheting-up of interest rates. As of the end of April, it had widened from the 65 basis points of the previous year-end to 76 basis points. Subsequently, however, this tendency gradually eased and as of the end of August, it returned to 65 basis points. The premium on short-term borrowings, meanwhile, maintained a slightly lower level than at the previous year-end.

**<Table Ⅰ- 18>**

**Korea's Sovereign Credit Ratings[1)]**

| | S&P | Moody's | Fitch IBCA |
|---|---|---|---|
| 1997 | A+ (10.24)<br>A- (11.25)<br>BBB- (12.10)<br>B+ (12.22) | A3 (11.27)<br>Baa1 (12.10)<br>Ba1 (12.21) | A+ (11.18)<br>A (12.3)<br>BBB- (12.11)<br>B- (12.23) |
| 1998 | BB+ (2.17) | - | BB+ (2.2) |
| 1999 | BBB- (1.25)<br>BBB (11.11) | Baa3 (2.12)<br>Baa2 (12.16) | BBB- (1.19)<br>BBB (6.24) |
| 2000 | - | - | BBB+ (3.30) |
| 2001 | BBB+ (11.13) | - | - |
| 2002 | A- (7.24, outlook: S)[2)] | A3 (3.28)<br>Upward adjustment of outlook (S→P,11.15)[2)] | A (6.27, outlook: S)[2)] |
| 2003 | - | Downward adjustment of outlook (P→N, 2.11)[2)] | - |
| 2004 | - | Upward adjustment of outlook (N→S, 6.11)[2)] | - |
| 2005 | A (7.27, outlook: S)[2)] | - | - |

Notes: 1) Figures in parentheses refer to the announcement dates.
2) P (Positive), S (Stable), N (Negative).

**<Table Ⅰ- 19>**

**Spreads on Foreign Exchange Stabilization Fund (FESF) Bonds and Short-term Borrowings**

(bp)

| | 2003 Dec. | 2004 Dec. | 2005 | | | | |
|---|---|---|---|---|---|---|---|
| | | | Feb. | Apr. | Jun. | Jul. | Aug. |
| FESF bonds (2013)[1)] | 45 | 65 | 61 | 76 | 65 | 60 | 65 |
| Short-term borrowings[2)] | 18 | 16 | 13 | 10 | 13 | 7 | 9 |

Notes: 1) Spread on US T-notes, period-end basis.
The number in the parenthesis refers to the maturity.
2) Spread on LIBOR, period-average basis.

# 5. Prices

**(Consumer Prices)**

**<Table Ⅰ- 20>**

**Major Consumer Price Indicators[1)]**

(%)

| | 2004 | | | 2005 | | | |
|---|---|---|---|---|---|---|---|
| | Year | 1st half | 2nd half | 1st half | Ⅰ | Ⅱ | Jul.~Aug. |
| Consumer prices | 3.6 (3.0) | 3.3 (2.0) | 3.8 (1.1) | 3.1 (1.6) | 3.2 (2.1) | 3.0 (-0.4) | 2.3 (0.8) |
| Agricultural, livestock and marine products | 8.9 (3.2) | 9.5 (3.0) | 8.3 (0.2) | 3.7 (2.0) | 3.7 (6.2) | 3.6 (-4.0) | -0.9 (2.3) |
| Industrial products | 2.6 (2.8) | 1.6 (1.7) | 3.6 (1.1) | 3.5 (2.3) | 3.3 (1.9) | 3.7 (0.4) | 3.7 (1.0) |
| (Petroleum products) | 8.9 (7.2) | 5.7 (5.5) | 12.1 (1.6) | 6.5 (5.3) | 5.0 (4.0) | 8.1 (1.2) | 8.5 (4.6) |
| Services | 3.1 (3.1) | 3.1 (1.9) | 3.0 (1.2) | 2.6 (1.1) | 2.9 (1.2) | 2.4 (-0.1) | 2.1 (0.3) |
| (Rents) | 1.6 (0.4) | 2.2 (0.5) | 1.0 (-0.1) | 0.0 (-0.3) | 0.2 (0.0) | -0.3 (-0.3) | -0.4 (0.0) |
| (Public service charges) | 2.5 (4.7) | 1.7 (1.7) | 3.4 (3.0) | 3.8 (0.4) | 4.4 (1.0) | 3.3 (-0.5) | 3.0 (0.6) |
| (Private services) | 4.1 (3.7) | 4.2 (2.8) | 3.9 (0.9) | 3.4 (2.2) | 3.5 (2.0) | 3.2 (0.2) | 2.9 (0.3) |
| Cost-of-living | 4.9 (4.5) | 4.3 (2.8) | 5.6 (1.6) | 4.6 (2.4) | 4.7 (3.3) | 4.5 (-0.8) | 3.4 (1.2) |
| Core inflation | 2.9 (2.9) | 2.6 (2.0) | 3.1 (0.9) | 2.8 (1.4) | 3.0 (1.4) | 2.5 (0.0) | 2.0 (0.2) |

Note : 1) Figures in parentheses refer to rates of increase of the last month of each period compared with the last month of the previous year.
Source: Korea National Statistical Office.

During the first eight months of 2005 the upward trend of consumer prices (CPI basis) was greatly blunted compared to the previous year, rising at a rate of 2.9% year-on-year. Broken down by period, the rate of CPI inflation stood at 3.2% in the first quarter, slightly lower than in the preceding fourth quarter. This reflected the stability of housing rents and of charges for individual services, which helped offset the increase in cigarette prices and the run-up in oil prices. From early in the second quarter, prices of petroleum products rose sharply, but they were to some extent counteracted by the stability of agricultural, livestock and fisheries prices and of charges for services. Consequently the second-quarter CPI inflation eased to 3.0%. In July and August, the rise in prices of agricultural, livestock and fisheries products and of petroleum products was largely negated by the statistical base-period effect of the sharp rise in CPI inflation a year earlier. For July, it therefore registered 2.5% and for August a rate of 2.0%, the lowest monthly figure since May 2000 (1.1%).

Looking at the movements of CPI inflation by commodity group during the first eight months of the year, petroleum product prices rose 7.0% under the impact of high oil prices, although this rate of increase was somewhat more moderate than in the preceding year (8.9%). The prices of industrial products rose 3.6% year-on-year, pushed up by higher cigarette and processed food prices. Thanks to improved shipments, the rise in the prices of agricultural, livestock and fisheries products was held to 2.5%. Service charges maintained a stable pattern of movements centering on housing rents and charges for individual services.

Meanwhile the rate of increase in the cost-of-living index, which consists of daily necessities that consumers buy frequently, showed a rise of 4.4% during the first eight months of the year, which was higher than the rate of increase in the CPI.

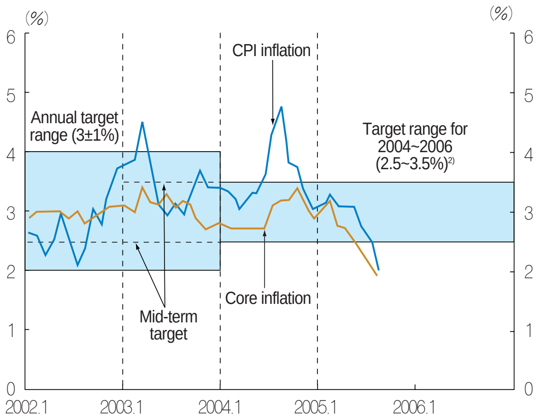
## (Core Inflation)

The rate of core inflation, which is the price indicator for the Bank of Korea's inflation target[1], stood at 2.6% year-on-year during the year to August, rather lower than in the previous year (2.9%). Viewed by period, core inflation exhibited a rate of 3.0% in the first quarter, the mid-point of the inflation target range. From early in the second quarter, it fell below 2.5%, the lower bound of its target range. It then dropped further to 2.1% in July and to 1.9% in August.

Looking at the contribution to core inflation by product during the first eight months of the year, that of industrial products (excluding petroleum products) rose from 0.6 percentage points to 0.9 percentage points and that of individual services (excluding piped-gas) from 0.4 percentage points to 0.5 percentage points. On the other hand, the contribution of livestock and fisheries product prices fell from 0.7 percentage points to 0.3 percentage points. That of charges for individual services similarly dropped from 1.2 percentage points to 1.0 percentage points. The contribution of housing rents remained unchanged at the 0.1 percentage points exhibited in the preceding half-year.

**<Figure Ⅰ- 28>**

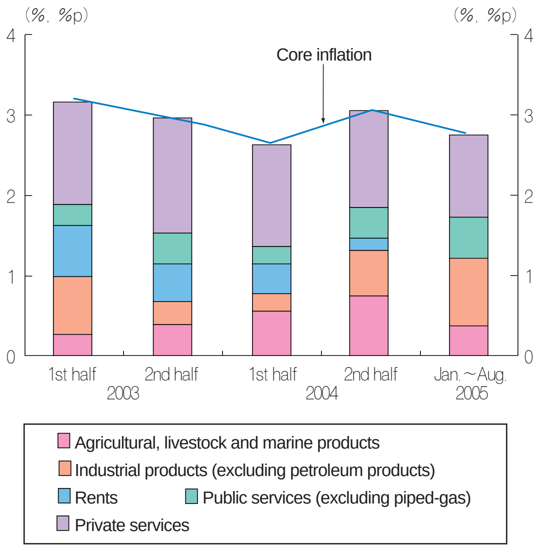
**CPI and Core Inflation[1]**




Notes: 1) Compared with the same period of the previous year.
2) Based on the average annualized rate of increase during the period.

**<Figure Ⅰ- 29>**

**Degree of Contribution[1] to Core Inflation**




Note: 1) Compared with the same period of the previous year.

1) The present inflation target has been set at a range of 2.5 ~ 3.5% for the period 2004~2006 in terms of the average annualized rate of core inflation (the CPI stripping out petroleum products and agricultural products apart from grains).

Examining the factors bringing about changes in core inflation by sector, on the demand side, upward pressures on prices appeared quite weak with the recovery of domestic demand progressing very sedately. On the cost side the run-up in international oil prices led to a sharp rise in import unit prices, but the overall upward pressure was largely defused by the appreciation of the Korean won.

**<Table Ⅰ- 21>**

**Differential between Rates of CPI and Core Inflation**

(%p)

| 2000 | 2001 | 2002 | 2003 | 2004 | 2005 Jan.~Aug. |
|---|---|---|---|---|---|
| 0.4 | 0.5 | -0.3 | 0.5 | 0.7 | 0.3 |

**<Table Ⅰ- 22>**

**Increase Rates of Major Prices and Degree of Contribution[1] by Products**

(%, %p)

| | | 2000~2003 | 2003 | 2005. Jan.~Aug. |
|---|---|---|---|---|
| CPI inflation | | 3.2 | 3.6 | 2.9 |
| Supply shock-related products[2] | | | | |
| 〈183.9〉 | Increase rates | 5.2 | 8.4 | 4.2 |
| | Contribution | 0.98 | 1.61 | 0.83 |
| Domestic demand-related products[3] | | | | |
| 〈515.9〉 | Increase rates | 3.1 | 2.7 | 1.8 |
| | Contribution | 1.61 | 1.41 | 0.95 |
| Other products[4] | | | | |
| 〈300.2〉 | Increase rates | 1.9 | 2.1 | 3.8 |
| | Contribution | 0.56 | 0.60 | 1.07 |
| Core inflation 〈883.5〉 | | 2.9 | 2.9 | 2.6 |

Notes: 1) Contribution to consumer prices. Figures in the bracket refer to weighting on consumer prices index (total weighting is 1,000.0).
2) Agricultural, livestock and fishery products, petroleum products, public transportation fare, piped-gas, etc.
3) Textile goods, domestic demand-related industrial products, private services, rents, etc.
4) Processed foods, computer-related products, semi-industrial products and public utilities charges except for public transportation fares and piped-gas.

Meanwhile, during the year to August 2005, the gap between the rate of increase in CPI inflation (2.9%) and core inflation (2.6%) narrowed considerably from the previous year’s 0.7 percentage points to stand at 0.3 percentage points. This occurred because the sharp slowdown in the rate of increase of the prices of agricultural products helped counteract the continuing rapid rate of increase in the prices of petroleum products. The rate of increase of prices of products vulnerable to supply shocks, which includes these items, fell sharply to 4.2% from its 8.4% the previous year. Their contribution to the rate of increase in consumer prices fell from 1.6 percentage points in the previous year to 80 basis points. In addition prices of domestic demand-related products depending on households incomes and consumption demand were limited to a 1.8% increase, meaning that the size of their contribution to the increase in CPI inflation narrowed from last year’s 1.4 percentage points to 1.0 percentage basis points. In contrast, there was a sharp rise from 2.1% in the previous year to 3.8% in the rate of increase of prices of other items, a category that includes both charges for public services, the scale of whose increase is set in line with the government’s policies related to prices, and industrial products, which are influenced by changes in domestic demand and international raw material prices. Consequently their contribution to the rate of increase in the CPI widened from 0.6 percentage points to 1.1 percentage points.

**<Table Ⅰ- 23>**

**Producer Prices[1)]**

(%)

| | 2004 | | | 2005 | | | |
|---|---|---|---|---|---|---|---|
| | Year | 1st half | 2nd half | 1st half | Ⅰ | Ⅱ | Jul.~Aug. |
| Producer prices | 6.1 (5.3) | 5.2 (4.3) | 6.9 (1.0) | 2.7 (0.6) | 3.3 (1.0) | 2.1 (−0.5) | 1.8 (1.1) |
| Goods | 7.5 (6.9) | 6.2 (5.7) | 8.8 (1.1) | 3.3 (0.5) | 4.1 (1.2) | 2.5 (−0.7) | 1.9 (1.5) |
| (Agricultural, forest and marine products) | 12.1 (−4.4) | 18.3 (4.7) | 6.3 (−8.7) | −2.5 (4.2) | −2.6 (11.8) | −2.4 (−6.8) | −7.6 (2.9) |
| (Industrial products) | 7.5 (8.1) | 5.6 (6.1) | 9.5 (1.8) | 4.1 (0.4) | 5.0 (0.7) | 3.1 (−0.3) | 2.8 (1.4) |
| (Electric power, water and gas ) | 0.9 (4.6) | −0.5 (0.6) | 2.2 (4.0) | 1.4 (−2.7) | 1.7 (−3.4) | 1.0 (0.7) | 2.2 (1.2) |
| Services | 2.8 (2.1) | 3.0 (1.1) | 2.7 (0.9) | 1.3 (0.5) | 1.3 (0.4) | 1.1 (0.1) | 1.1 (0.5) |

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

**<Table Ⅰ- 24>**

**Export and Import Prices[1)]**

(%)

| | | 2004 | | | 2005 | | | |
|---|---|---|---|---|---|---|---|---|
| | | Year | 1st half | 2nd half | 1st half | Ⅰ | Ⅱ | Jul.~Aug. |
| Export prices | Won-basis | 6.2 (−2.8) | 4.4 (2.4) | 8.0 (−5.1) | −6.3 (−3.0) | −4.9 (−0.7) | −7.6 (−2.3) | −7.9 (2.2) |
| | Contract currency-basis | 9.6 (9.7) | 6.7 (5.9) | 12.5 (3.6) | 7.5 (1.8) | 8.8 (3.9) | 6.2 (−2.0) | 3.8 (1.2) |
| Import prices | Won-basis | 10.2 (0.7) | 8.2 (5.1) | 12.1 (−4.2) | 0.5 (6.2) | 0.1 (3.9) | 0.9 (2.2) | 3.2 (5.4) |
| | (Raw materials) | 12.2 (2.7) | 9.6 (6.7) | 14.8 (−3.7) | 2.6 (8.4) | 2.1 (5.1) | 3.2 (3.1) | 5.6 (6.1) |
| | (Capital goods) | −0.6 (−9.7) | 1.0 (−3.5) | −2.3 (−6.4) | −11.5 (−6.5) | −11.2 (−4.3) | −11.8 (−2.3) | −11.9 (0.1) |
| | (Consumer goods) | 5.1 (−5.1) | 4.2 (1.1) | 6.0 (−6.1) | −5.1 (0.5) | −3.8 (2.5) | −6.3 (−2.0) | −3.9 (3.3) |
| | Contract currency-basis | 13.2 (13.4) | 9.9 (8.5) | 16.5 (4.6) | 15.1 (11.5) | 14.3 (8.8) | 15.9 (2.5) | 16.3 (4.5) |
| Exchange rate[2)] | | 4.2 | 3.4 | 5.0 | 14.9 | 14.5 | 15.3 | 12.5 |

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) ₩/US$ basis, year-on-year average rate of appreciation of won against the US dollar during the given period.

## (Producer Prices)

During the first eight months of 2005, the Producer Price Index (PPI) rose 2.5% year-on-year, its upward pace greatly slackening from the previous year. Viewed by period, during the first quarter the rate of increase stood at 3.3% in response to the fall in prices of agricultural and fisheries products and the stability of charges for services. At the beginning of the second quarter, the upward trend of industrial product prices flattened out while the downward trend of farm, forestry and fishing prices was maintained, so that the rate of increase in the PPI fell to 2.1%. This trend continued with a further drop to 2.0% in July and to 1.4% in August.

Viewed by commodity group, producer prices of agricultural, forestry and fisheries products fell 3.8% year-on-year during the year to August period. Charges for services were held to a 1.2% rise by the gentleness of the revival of domestic demand. Industrial product prices showed a fairly large-scale rise as distribution costs were pushed up for processed foods while petroleum-product prices rose sharply owing to the run-up in international oil prices. Consequently, producer prices for industrial products registered an increase of 3.7%, which was relatively higher than that of those for other product groups.

## (Export and Import Prices)

During the first eight months of 2005, the unit price of exports (Korean won basis) fell 6.7% year-on-year, influenced by the Korean won’s strengthening trend. On a contract-currency basis, which excludes the effect of changes in the exchange rate, export prices nevertheless rose 6.5%.

Import prices (Korean won basis) rose no more than 1.2% year-on-year, thanks to the offsetting effects of the Korean won's appreciation on the effect of the run-up in prices of raw materials centering on crude oil. Seen on a contract-currency basis, which excludes the influence of changes in exchange rates, import prices climbed 15.4%, showing that the appreciation of the domestic currency was the principal factor making for the stability of import prices.

<Table Ⅰ - 25>

**House Prices and Leasehold Deposits[1)]**

(%)

| | 2004 | | | 2005 | | | | |
|---|---|---|---|---|---|---|---|---|
| | Year | 1st half | 2nd half | 1st half | Ⅰ | Ⅱ | Jul. | Aug. |
| House Prices | -2.1 | -0.1 | -2.0 | 2.4 | 0.4 | 1.9 | 0.8 | 0.4 |
| Apartment | -0.6 | 1.0 | -1.5 | 3.7 | 0.9 | 2.8 | 1.1 | 0.5 |
| Seoul | -1.0 | 1.6 | -2.6 | 5.7 | 1.2 | 4.4 | 1.9 | 0.4 |
| (Gangnam) | -1.3 | 1.9 | -3.2 | 9.5 | 2.1 | 7.2 | 2.6 | 0.2 |
| Leasehold deposit | -5.0 | -0.9 | -4.1 | 0.8 | 0.2 | 0.6 | 0.1 | 0.2 |
| Apartment | -2.7 | 0.5 | -3.2 | 2.1 | 0.7 | 1.4 | 0.3 | 0.4 |
| Seoul | -4.4 | -0.2 | -4.2 | 0.7 | -0.1 | 0.8 | 0.3 | 0.7 |
| Land prices | 3.9 | 2.5 | 1.4 | 2.7 | 0.8 | 1.9 | 0.5 | 0.9 |

Note: 1) Compared with the last month of the preceding period.
Sources: Ministry of Construction and Transportation, Kookmin Bank.

**(Real Estate Prices)**

Real estate prices marked a steeply-upward trend during the first eight months of 2005. Contract prices for the sale of housing, which had shown stability in the wake of the measures taken on October 29, 2003, shifted back to an upward trend in late January as anticipations of a run-up in their prices became widespread. In consequence, the contract selling prices of apartments nationwide rose by 5.3% during the year to August. Most conspicuously, they showed a high rate of increase of 12.7% in the Gangnam area of Seoul. From mid-July, nevertheless, their rate of increase showed a gentler pattern, influenced by government measures to curb additional housing finance loans and the expected unveiling at the end of August of a comprehensive package of real-estate stabilization measures. Housing lease deposit prices, which mainly move in accordance with real demand, meanwhile, presented a relatively stable picture.

Land prices accelerated their upward pace from March. There were especially large-scale rises in land prices in Greater Seoul and other big cities having strong demand for further development, areas of Chungcheong Province related to the construction of a new administrative complex city and sites chosen as 'company towns'.

# Ⅱ. Conduct of Monetary Policy

## 1. Call Rate Target

**(Call Rate Target Maintained Unchanged from December 2004)**

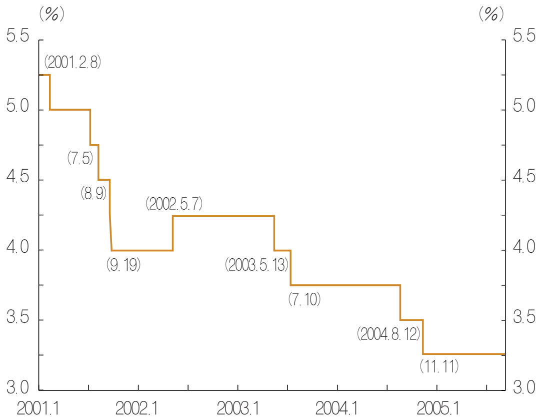
The Bank of Korea maintained the call rate target unchanged throughout the first eight months of the year under review, after having lowered it to 3.25% in November 2004. In addition, interest rates on Aggregate Credit Ceiling Loans and on Liquidity Adjustment Loans remained at 2.0% and 3.0%, respectively.

Its monthly interest-rate decisions were made based on the judgment that the accommodative stance of monetary policy needed to be maintained for some time, since the recovery of the real economy was very slow, although showing gradual improvement accompanied by stable prices. There was, however, a greater or less degree of variation in the background to monthly decisions in terms of the real economy, price movements, and financial and asset markets.

First, in the real economy, there were signs of a recovery in domestic demand, as economic agents' confidence improved conspicuously from the start of 2005, helped by rising stock prices. The consumer expectation index, a key indicator measuring consumer sentiment over the next six months, rose significantly to exceed 100 in March, and indexes related to private consumption and facilities investment exhibited partial improvement. Consequently, anticipations spread of an earlier onset of the economic recovery than initially

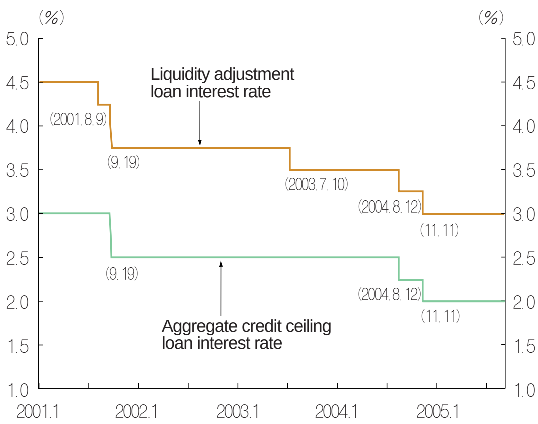
**<Figure Ⅱ-1>**

**Overnight Call Rate Target**



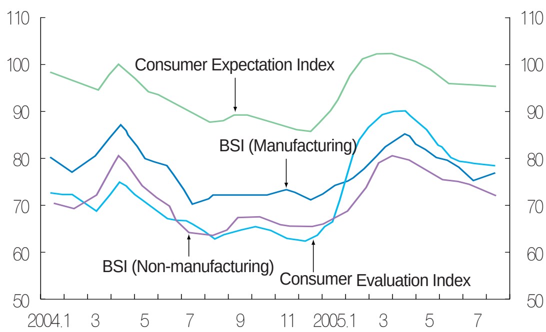

**<Figure Ⅱ-2>**

**Interest Rates on Aggregate Credit Ceiling Loans and on Liquidity Adjustment Loans**



**<Figure Ⅱ-3>**

**Business Survey Index (BSI)[1] and Consumer Sentiments[2]**




Notes: 1) Refers to the share of "optimistic" respondents minus that of "pessimistic" respondents + 100
2) Consumer Expectation (Evaluation) Index 100 refers to a situation where the number of households expecting (evaluating) business activities and living conditions for the next six months (present time) optimistically compared with the present time (six month ago) is equal to those taking pessimistic view.
Source: Korea National Statistical Office.

**<Table Ⅱ-1>**

**Major Real Economic Indicators[1]**

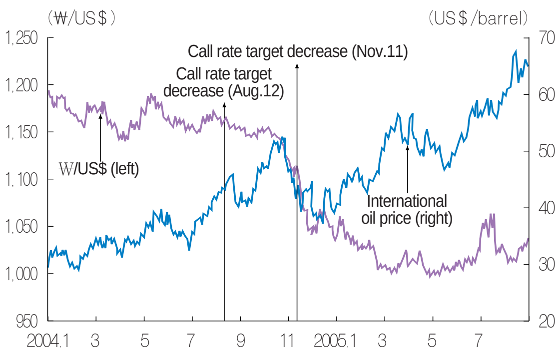
(%)

| | 2004 | 2005 | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Dec. | Jan. | Feb. | Mar. | Apr. | May | Jun. | Jul. |
| Exports[2] | 17.6 | 18.2 | 6.6 | 13.1 | 6.5 | 11.0 | 9.6 | 10.9 |
| Consumer goods sales | 2.7 | -4.0 | 3.8 | 4.0 | 2.9 | 3.6 | 3.5 | 4.9 |
| Facilities investment estimates | -1.8 | 16.0 | -3.5 | 1.6 | -0.2 | 7.7 | -3.1 | 4.7 |
| Construction work-in hand | -0.2 | 4.9 | -2.4 | 5.3 | 8.2 | 11.1 | 11.6 | 5.3 |
| Manufacturing production | 4.6 | 14.6 | -8.0 | 4.6 | 3.7 | 4.1 | 4.1 | 7.2 |
| Service activities | 0.6 | 1.0 | -0.5 | 1.6 | 1.9 | 2.6 | 2.7 | 4.2 |

Notes: 1) Compared with the same period of the precious year.
2) Customs clearance basis.
Sources: Korea National Statistical Office, Korea Customs Service.

**<Figure Ⅱ-4>**

**₩/US$ and International Oil Prices[1]**




Note: 1) Based on Brent crude oil.

expected as the effects of the long-maintained accommodative monetary policy stance and the government's fiscal expansion designed to stimulate a business recovery became visible. However, GDP growth during the first quarter registered just 2.7% year-on-year and 0.4% (seasonally-adjusted) compared with the previous period, as improvement of private consumption and facilities investment was sluggish and construction investment stayed in the doldrums. There were some concerns from the second quarter onwards generated by the possibility of heightened uncertainty surrounding economic prospects, as the environment deteriorated both at home and abroad with the run-up in international oil prices persisting longer than had been expected and the Korean won remaining strong against the US dollar. The real economy, though, showed stirrings of a gradual recovery. Exports remained resilient, and in terms of domestic demand, private consumption showed a convincing pace of recovery and construction investment was on the rise, although the improvement in facilities investment fell short of expectations. GDP growth during the second quarter rose to 3.3% year-on-year and 1.2% (seasonally-adjusted) compared with the previous period, while the real economy continued to show improvement in the third quarter as well.

The pace of price rise slowed, as demand pressures remained weak owing to the gentle pace of economic recovery, and on the cost side, there was only weak upward pressure thanks to the strengthening of the Korean won against the US dollar. Consumer price inflation showed stable movements as the hike in prices of petroleum products resulting from the run-up in international oil prices was offset by the steadiness of prices for services. Its year-on-year rate remained around 3.1~3.3% until May, and eased further to the 2% level from June. The year-on-year rate of core inflation had declined to the 2% level from March and dropped below 2.5%, the lower bound of inflation target range, from June. However, latent factors making for price instability appeared to remain. There were concerns that the trend of high oil prices might continue longer than expected as oil prices defied forecasts by remaining on a steeply rising course. Furthermore, real estate prices continued to show unstable movements from the start of 2005.

**<Table Ⅱ-2>**

**Real Estate Prices[1)]**

(%)

| | 2004 | 2005 | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Dec. | Jan. | Feb. | Mar. | Apr. | May | Jun. | Jul. | Aug. |
| Housing sale | -0.4 | -0.3 | 0.3 | 0.4 | 0.6 | 0.5 | 0.8 | 0.8 | 0.4 |
| (Apartment) | -0.4 | -0.3 | 0.5 | 0.6 | 0.8 | 0.8 | 1.2 | 1.1 | 0.5 |
| Land | 0.6[2)] | 0.2 | 0.2 | 0.3 | 0.5 | 0.6 | 0.8 | 0.5 | 0.5 |

Notes: 1) Compared with the previous period.
2) For the fourth quarter.
Sources: Kookmin Bank, Ministry of Construction & Transportation.

**<Table Ⅱ-3>**

**Regions of a Sudden Rise in Apartment Sale Prices[1)]**

(%)

| | Rate of increase | | Regions with above a 0.8%, monthly average rate of increase from Feb. 2005 to Jun. 2005 | |
|---|---|---|---|---|
| | Nation-wide | Seoul | Number[2)] | Major regions |
| 2005. Feb. | 0.5 | 1.0 | 18 | Bundang (3.6), Gangnam (2.8), Songpa (2.6), Seocho (2.0), Yongin (1.4) |
| Mar. | 0.6 | 0.5 | 25 | Above+Daejeon (1.4) |
| Apr. | 0.8 | 1.2 | 37 | Above+Gwacheon (4.2), Pyeongchon (1.3) |
| May | 0.8 | 1.0 | 36 | Above+Uiwang (1.4), Changwon (2.6), Daegu (1.3), Ilsan (0.8) |
| Jun. | 1.2 | 2.2 | 39 | Above+Guro (1.3), Hanam (1.0), Anseong (1.2) |

Notes: 1) Compared with the previous month.
2) Among 139 domestic administrative districts, surveyed by Kookmin Bank.
3) Figures in parentheses refer to rates of increase compared with the previous month of each region (%).

In the real estate market, house prices, which had been stabilized with the introduction of the real estate counter-measures on October 29, 2003, started to surge from late January 2005, driven by those of apartments in Seoul and new towns in the surrounding areas. Particularly, as it became known that sales prices of apartments in Pangyo would be higher than expected and there would not be sufficient supply of medium and large-sized apartments, prices accelerated significantly from March centering on those of medium and large-sized apartments in the areas neighboring Pangyo. This trend also spread to some provincial cities including Daejeon, Daegu and Changwon. Land prices also climbed significantly centering around areas designated for development. Accordingly, some advocated raising the policy rate to tackle the run-up in real estate prices, but it was not considered appropriate to adjust the call rate target to stabilize the real estate market given the bleakness of the economic outlook, because adjustment of the policy rate affects the economy as a whole. In addition, measures aimed at restricting housing finance loans were implemented in early July and the government planned to introduce a comprehensive package of real estate stabilization measures in late August so that it was desirable to wait and see what effect they would have.

In the financial markets, liquidity conditions were favorable overall and lending by financial institutions, including loans to SMEs and to households, gradually increased. Long-term market interest rates rose substantially until mid-February due to imbalances between bond demand and supply, but later showed downward stability amid weakening expectations of economic recovery. However, the rates rebounded from June onwards owing to growing expectations of economic recovery and a possible increase in the call rate target to counter rising real estate prices. The Korea Composite Stock Price Index (KOSPI) remained on a strongly upward trend, except for a correction phase during March and April. It reached 1,083 as of the end of August, a 21% rise from the end of the previous year, buoyed up by inflows of long-term investment funds such as pension and installment type funds and by expectations of economic recovery. Overall financial conditions aided the recovery in business activity by way of the continued accommodative stance. However, concerns were also voiced over the side-effects of the maintenance of the accommodative stance, such as the increased upward pressure on house prices resulting from a sharp rise in housing finance loans, the concentration in short-term deposits at financial institutions that might be accompanied by the weakening of financial market stability.

Meanwhile, the US Federal Reserve had raised its target for the Federal Funds rate ten times from June 2004 by 25 basis points on each occasion, bringing the figure to 3.5% by August 2005. As a result, with US interest rates running higher than Korean interest rates, the Korean interest rate premium underwent a partial inversion, and there were concerns raised regarding a possible outflow of capital. However, given that Korean long-term interest rates were much higher than

<Table Ⅱ-4>

**Expectation about Overnight Call Rate Target Decision[1)]**

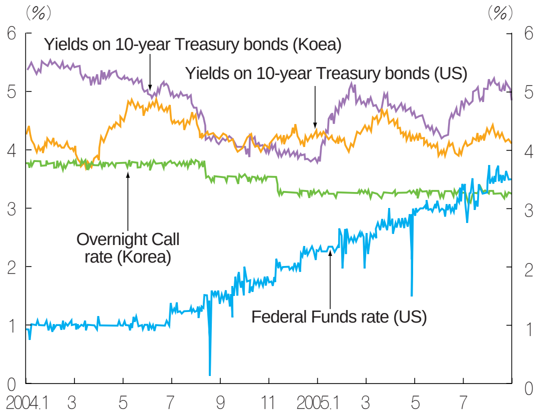
(respondent ratio, %)

| Period for forecast | 2005. Ⅲ | | | 2005. Ⅳ | | |
|---|---|---|---|---|---|---|
| Monitoring date | Mar. | Apr. | May | Jun. | Jul. | Aug. |
| Increase | 48 | 51 | 23 | 53 | 53 | 54 |
| Maintain | 38 | 41 | 71 | 32 | 36 | 42 |
| Decrease | 14 | 8 | 6 | 15 | 11 | 4 |

Note: 1) A few days before the monthly Monetary Policy Committee meetings to determine the monetary policy direction, the Bank conducts a regular survey of one hundred economists of financial institutions, corporations, colleges, labs and organs of public opinion concerning their expectations as to the decision on the policy rate.

<Figure Ⅱ-5>

**Long- and Short-term Interest Rates in Korea and the US**



**<Table Ⅱ-5>**

**Policy Rate Changes in Major Countries**

(%)

| | US | UK | ECB |
|---|---|---|---|
| 2001. Dec. | 1.75 | 4.00 | 3.25 |
| 2002. Dec. | 1.25 | 4.00 | 2.75 |
| 2003. Dec. | 1.00 | 3.75 | 2.00 |
| 2004. Dec. | 2.25 | 4.75 | 2.00 |
| 2005. Feb. | 2.50 | | |
| Mar. | 2.75 | | |
| May | 3.00 | | |
| Jun. | 3.25 | | |
| Aug. | 3.50 | 4.50 | |

Source: Central banks of individual countries and the ECB.

**<Table Ⅱ-6>**

**Planned and Actual Fiscal Disbursements**

(trillion won)

| | 2005 plan | 1st half of 2005 | | Compared with the 1st half of 2004 |
|---|---|---|---|---|
| | | Planned | Disbursed | |
| Total | 169.9 | 100.2(59.0) | 100.8(59.3) | +13.3 [+4.3] |
| Budgets | 121.5 | 72.3(59.5) | 73.0(60.1) | +7.8 [+5.4] |
| Funds | 23.8 | 12.6(53.1) | 12.1(51.0) | +1.9 [+2.3] |
| Public corporations | 24.6 | 15.3(62.0) | 15.7(63.6) | +3.6 [-0.4] |

Notes: 1) Figures in parentheses refer to the ratios of actual disbursements to annual plans.
2) Figures in square brackets refer to differences in the actual disbursement ratios.

**<Table Ⅱ-7>**

**Fiscal Balance**

(trillion won)

| | 1st half of 2004 | 2005 | | | |
|---|---|---|---|---|---|
| | | Budget | Ⅰ | Ⅱ | 1st half |
| Fiscal balance (A-B-C) | -8.0 | -8.2 | -8.7 | -10.4 | -19.1 |
| Revenue (A) | 89.4 | 199.7 | 47.5 | 46.2 | 93.7 |
| Expenditure (B) | 92.1 | 194.1 | 52.6 | 52.6 | 105.2 |
| Adjustment[1] (C) | 5.3 | 13.8 | 3.7 | 3.9 | 7.6 |

Note: 1) Balance of society security funds - repayment of public funds.

US interest rates, and that foreign investment is accompanied by exchange rate risk, the fact of the US policy rate running higher than that of Korea was not seen as a factor making for serious disturbance in Korean financial and foreign exchange markets. The European Central Bank maintained its policy rate at 2.0% in 2005, while the Bank of England cut its policy rate by 25 basis points to 4.5% in August. The People's Bank of China changed its foreign exchange regime to one based on market supply and demand with reference to a basket of currencies, and adjusted the exchange rate of the yuan from 8.28 per US dollar to 8.11 per US dollar. This, though, had little or no impact on Korean financial and foreign exchange markets.

**(Monetary Policy Operation in Line with Fiscal and Foreign Exchange Policies)**

The government maintained its expansionary stance on fiscal policy during the first half of 2005 in order to support economic recovery. With fiscal expenditures brought forward, the ratio of actual disbursements to annual plans during the first six months of the year stood at 59.3%, 4.3 percentage points higher than a year earlier, and accordingly, the fiscal account registered a deficit of 19.1 trillion won, up 4.3 percentage points year-on-year. Given that the frontloading of the disbursement of planned annual expenditures would increase the shortfall of government expenditure to revenue, the Bank of Korea set the ceiling on the government's temporary borrowings from the Bank of Korea for 2005 at 20.7 trillion won[2], an increase of 10.07 trillion won from 2004. Meanwhile, since a large part of the fiscal expenditures were executed during the first half,

2) The same amount as the ceiling on government's temporary borrowings or on issuance of fiscal securities in 2005 set by the National Assembly on December 31, 2004.

concerns were raised that the fiscal policy stance might shift in the direction of tightening in the second half.

In addition, the exchange rate is, in principle, decided by the interplay of supply and demand in the foreign exchange market. However, the Bank of Korea implements smoothing operations to deal with abrupt swings in the exchange rate caused by temporary imbalances between supply and demand or radical changes in market sentiment. The Korean won had continued to strengthen against the US dollar in particular from late October 2004 onwards and this trend was maintained into the early part of this year, leading the won to touch less than 1,000 won per dollar in late April. The US dollar, however, maintained a strengthening trend in international financial markets due to the steady ratcheting-up of the policy rate by the US Federal Reserve, and thus the exchange rate generally fluctuated within a range of 1,010~1,050 won per dollar from mid-June onwards.

**(Liquidity Adjustment to Maintain the Call Rate Target)**

In order to facilitate the formation of actual call rates at the level of the target decided by the Monetary Policy Committee, market liquidity was adjusted by way of the issue of Monetary Stabilization Bonds (MSBs) and the purchase and sale of securities under repurchase or resale conditions (RPs).

In the early part of 2005, the supply of high-powered money through the foreign sector had continued thanks to the current account surplus. In addition, high-powered money was supplied on an increased scale through the government sector with fiscal expenditures being brought forward. The Bank of Korea, therefore, absorbed the excess reserves of

**<Table Ⅱ-8>**

**Reserve Base (RB) and Liquidity Adjustment[1)]**

(%)

| | 2002 Dec. | 2003 Dec. | 2004 Dec. | 2005 | |
|---|---|---|---|---|---|
| | | | | Jun. | Aug. |
| RB demand (A) | 34.8 | 37.1 | 37.4 | 37.8 | 38.6 |
| RB supply (B) | 116.8 | 144.7 | 179.1 | 196.9 | 199.7 |
| Government | -10.9 | -3.5 | -1.9 | 3.4 | 5.7 |
| Private | -5.2 | -17.8 | -32.6 | -35.8 | -36.6 |
| Foreign | 138.0 | 173.7 | 213.9 | 219.5 | 221.8[2)] |
| Others | -5.1 | -7.7 | -0.2 | 9.7 | 8.9[2)] |
| Liquidity adjustment (B-A) | 82.0 | 107.6 | 141.6 | 159.0 | 161.1 |
| MSBs | 84.4 | 106.9 | 142.3 | 157.7 | 158.4 |
| Net sale of RPs | -2.4 | 0.7 | -0.7 | 1.3 | 2.7 |

Notes: 1) Based on monthly average.
2) Before foreign exchange revaluation.

**<Table Ⅱ-9>**

**MSBs Outstanding and Interest Payments on Them**

(trillion won)

| | 2001 | 2002 | 2003 | 2004 | 2005 Jan.~Aug. |
|---|---|---|---|---|---|
| Outstanding[1] | 79.1 | 84.3 | 105.5 | 142.8 | 159.8 |
| Interest payments | 4.9 | 4.8 | 5.0 | 5.6 | 4.1 |

Note: 1) Period-end basis.

financial institutions through the issue of MSBs to the market. Consequently, the outstanding balance of MSBs increased from 142.8 trillion won at the end of 2004 to 159.8 trillion won at the end of August 2005. This accumulation of MSBs outstanding, entailing side-effects such as upward pressure on market interest rates and an increase in issuance costs, has imposed difficulty on the operation of monetary policy. In May 2005, as a part of bids to mitigate the side-effects, the Bank of Korea introduced currency swap transactions with the National Pension Fund, absorbing Korean won in exchange for foreign reserves to be repurchased at maturity.

<Box Ⅱ-1>

## How a Higher Policy Rate in the US than Korea Affects Korean Financial and Foreign Exchange Markets

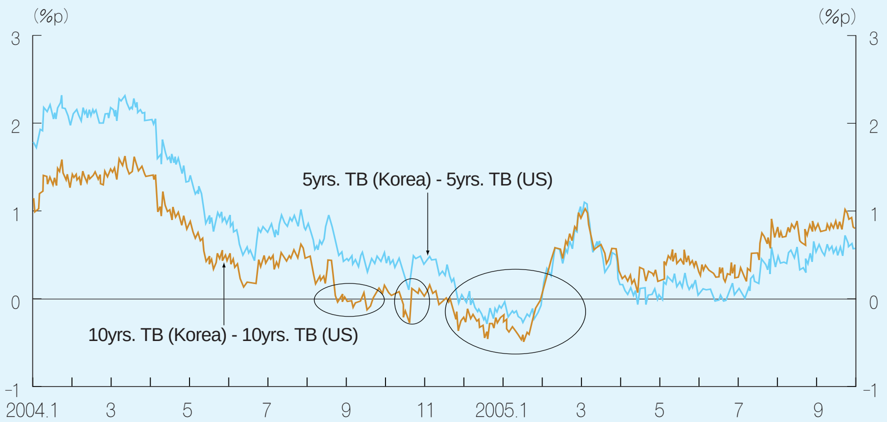
The US Federal Reserve raised its target for the Federal Funds rate ten times from June 2004 to August 2005 by 25 basis points on each occasion. The Bank of Korea, meanwhile, cut its call rate target to 3.25% in November 2004 and maintained it at that level throughout the first eight months of 2005. This brought about a situation from August 2005 where the US policy rate was higher than Korea's.

Considering the following points as a whole, however, it is unlikely that this inversion of the interest rate gap will act as a factor seriously unsettling the Korean financial and foreign exchange markets.

First, the inversion of the interest rate spread does not directly bring about an outflow of domestic capital, since the policy rate is applied in the call market. Even when the Federal Funds rate target exceeded the Korean call rate target by 25~150 basis points from June 1999 through March 2001, no serious problems arose.

Second, no inversion of the spread between US and Korean long-term interest rates has yet occurred, although the US policy rate is presently higher than the Korean policy rate. Furthermore, since US and Korean long-term interest rates are currently moving in the same direction, there is little likelihood of a reversal of the interest rate spread on them for the time being. In fact, the premium on Korean long-term rates over US long term rates (10-year Treasuries) turned negative in the second half of 2004 after the spread between them had narrowed significantly. From early this year, though, Korean long-term rates rose by a large margin so that the inversion of the premium became much less pronounced and as of the end of August 2005, Korean long-term rates stood at 4.83%, 82 basis points higher than US rates.

**Long-term Interest Rates' Spread between Korea and the US**



Third, even in the event of an inversion of the US and Korean long-term interest rate spread, this might not lead to capital outflows. Capital flows between countries may be influenced by interest rate differentials, but they also carry exchange rate risk and are affected by other factors including sovereign ratings.

Fourth, since foreign funds for portfolio investment are mostly directed to the stock market (98% of their outstanding was in listed stocks as of the end of June 2005), foreign stock investment is more likely to be influenced by stock market conditions than by the interest rate differential.

**Flows of Foreign Funds for Portfolio Investment**

(billion dollar)

| | 2004 | | | | 2005 | |
|---|---|---|---|---|---|---|
| | Ⅰ | Ⅱ | Ⅲ | Ⅳ | Ⅰ | Ⅱ |
| Inflow | 32.7 | 30.9 | 24.2 | 28.4 | 34.6 | 31.3 |
| Outflow | 23.9 | 30.3 | 22.1 | 30.5 | 34.7 | 32.5 |
| Net | 8.8 | 0.6 | 2.1 | -2.1 | -0.1 | -1.1 |

## 2. Other Monetary and Credit Policies

### (Strengthening Support for SMEs)

The Bank of Korea operated its Aggregate Credit Ceiling with a view to strengthening financial support for small and medium enterprises (SMEs).

First, given that expansion of corporate facilities investment is a policy priority not only for economic recovery but also for medium and long-term development of the economy, the Bank of Korea improved the Aggregate Credit Ceiling from August 2005 so as to encourage financial institutions to provide SMEs with loans for facilities investment. The 'Ceiling on SMEs Facilities Investment Fund Support' was set at approximately 1.3 trillion won (about 30% of the quota allocated to the BOK's regional branches) of funds under the Aggregate Credit Ceiling (4.4 trillion won), and this was allocated to banks in accordance with their lending performance on facilities investment loans to SMEs. Also, incentives for financial institutions to provide facilities loans to SMEs were strengthened by considering additionally their lending performance to SMEs for facilities investment when allocating quotas to individual institutions under the Aggregate Credit Ceiling. Given that the interest rate on the BOK's Aggregate Credit Loans is 2.0% annually, this change is expected to facilitate fundraising by SMEs for facilities investment through borrowings from financial institutions.

In line with this, incentives for financial institutions to comply with the ratio of lending to SMEs were strengthened from May, by additionally allocating the net amount of quota deduction from banks that had

**<Table Ⅱ-10>**

**Aggregate Credit Ceiling Allocations[1]**

(trillion won)

| Sorting | | Amount |
|---|---|---|
| Quota allocated to financial institutions | Quota to support settlement | 2.5 |
| | General quota | 2.5 |
| | Sub total | 5.0 |
| Quota allocated to the BOK's regional branches | | 4.4 |
| Retained reserve | | 0.2 |
| Total | | 9.6 |

Note: 1) As of the end of August 2005.

**<Table Ⅱ-11>**

**Fund Operation Performance Evaluation Ratios**

(%)

| Prior to alternation | | Following alternation | |
|---|---|---|---|
| Status of interest operations | 30 | Status of interest operations | 30 |
| Status of management | 20 | Facilities loans to SMEs | 20 |
| Ratio of credit-based lending to SMEs | 20 | Ratio of credit-based lending to SMEs | 20 |
| Degree of compliance with policies[1] | 30 | Degree of compliance with policies[1] | 30 |

Note: 1) Reflects rollover ratio on lending to SMEs (10%), the weight of line-of-credit lending to SMEs (10%) and degree of cooperation in policy operation (10%).

failed to meet their ratio of SME lending to banks that had shown a relatively huge increase in their lending to SMEs. Besides this, since the Bank of Korea only normally conducts joint examinations of financial institutions' performances at two to three-year intervals, breaches of regulations and errors related to lending performance was not to be picked up on and corrected at an early stage. In order to minimize such problems, the Bank determined to redirect the quota deduction from banks that had been unfairly allocated funds under the Aggregate Credit Ceiling to other banks.

Meanwhile, the Bank of Korea made an emergency allocation of 10 billion won of the Aggregate Credit Ceiling quota (20 billion won in terms of the amount of lending to be extended by financial institutions) for Gangneung in an effort to provide funds for SMEs that had suffered damage as a consequence of the forest fires that had raged in the Yangyang and Goseong areas of Gangwon province in April 2005.

**(Launch of Currency Swaps Linked to Foreign Currency Loans)**

In an attempt to promote corporate investment, to facilitate banks' foreign currency operations and to reduce the burden of their currency management, the Bank of Korea introduced a system of currency swaps linked to foreign currency loans in July 2005. Under these arrangements, the Bank of Korea provides foreign exchange banks with foreign currency of up to 5 billion dollars upon receipt of the Korean won equivalent. The banks sell back the foreign currency at maturity after using it to extend loans for capital goods imports and for overseas working capital.

<Table Ⅱ-12>

**Monthly Schedule for MSB Tenders by Maturity**

| Week[1] | Prior to alternation | Following alternation |
|---|---|---|
| First | 2-years · 91-days | 91-days |
| Second | 364-days | 2-years · 182-days |
| Third | 2-years · 91-days | 91-days |
| Fourth | 182-days | 2-years · 364-days |

Note: 1) Tendered on Tuesday for Wednesday issue.

<Table Ⅱ-13>

**Counterfeit Notes[1]**

(the number of notes)

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2004 1st half | 2005 1st half |
|---|---|---|---|---|---|---|---|
| All denominations | 1,142 (-17.1) | 1,547 (35.5) | 3,016 (95.0) | 3,896 (29.2) | 4,353 (11.7) | 2,038 (5.5) | 6,363 (212.2) |
| 5,000 won banknote | 71 | 235 | 931 | 437 | 987 | 331 | 4,639 (1,301.5) |

Note: 1) Figures in parentheses refer to the rates of increase compared with the same period of the previous year (%).

## (Changes in MSBs Bidding Schedule)

In order to help smooth the issuance of Monetary Stabilization Bonds (MSBs), the Bank of Korea changed the schedule for bidding for MSBs in March 2005. First, the bidding dates for the two-year MSB, which had been issued in the first and third weeks of every month together with the three-year Treasury bond[3], serving as a factor raising interest rates, were changed to every second and fourth weeks. Also, given that MMF deposits at Asset Management Companies, the major bidders for MSBs with short-term maturities, see an outflow at the end of the month and a renewed inflow at the beginning of the next month, the bidding for the 182-day MSB was changed from the fourth week of the month to the second week. Bidding for the 364-day MSB that had been conducted in the second week was changed to take place every fourth week, together with the two-year MSB. Meanwhile, in order to facilitate the steady supply of MSBs of the various maturities, the volume of the auction on each occasion was set at 1.5 trillion won for 91-day MSBs, one trillion won for both 182-day and 364-day MSBs, and 2.5~3.0 trillion won for two-year MSBs.

## (New Banknote Issuance Plan)

The Bank of Korea decided to issue new banknotes of the 10,000-, 5,000- and 1,000-won denominations, taking the view that measures to prevent counterfeit money were urgently needed given the huge increase in counterfeit notes over the past few years. The new banknotes will be reduced in size to the average for those of other OECD members and will have

3) Bidding and issuance of Treasury Bonds take place in the first week of every month for three-year bonds, the second week for five year bonds and the third week for ten-year bonds. Bids are accepted on the Monday of the relevant week and issue takes place on the Tuesday.

anti-counterfeiting features such as holograms. Changes will be made in the design of banknotes to make them give a more modern impression. The 5,000 won banknote, the counterfeiting of which has been the most prevalent, will be the first to be issued. It will be launched in the first half of 2006, being followed by the issuance of new 10,000 and 1,000 won banknotes in 2007.

**(Heightening the Transparency and Credibility of Monetary Policy)**

The Bank of Korea continued its efforts to heighten the transparency and credibility of its monetary policy.

First, the minutes of the Monetary Policy Committee (MPC) meetings are now released to the public earlier than before in order to facilitate communication with the financial markets. Whereas the minutes were previously only published in Monthly Bulletin two months after the relevant MPC meeting, they have since April 2005 been put up on the Bank of Korea’s website on the first Tuesday (the next business day if this is a holiday) six weeks after the MPC meeting. As a result, points made during the meeting can be conveyed more promptly to the financial markets.

Also, in order to heighten the credibility of monetary policy and help the general public improve their understanding of it, the Bank of Korea provides economics education for students in elementary, middle and high schools, teachers of social studies, the general public, college students and soldiers. This is carried out in cooperation with its regional branches and centers around the Public Economics Education Center, which was reorganized and expanded from the former Economics Information Office in March 2005. The ‘Friday Economic Lectures of the Bank of Korea’ are also given every Friday. Furthermore, in March the Bank of Korea published a set of books entitled 'Simple and Easy Economics' in a bid to make it easier and more interesting for the public to understand the economy. The four books of this set address the different audiences represented by elementary, middle and high school students and the general public. They are distributed free of charge to schools, related educational organizations and local governments.

## 3. Financial Market Stability

### (Monitoring and Reacting to the State of the Financial Markets)

**<Table Ⅱ-14>**

**Household Loans and Credit Card Arrears Rates[1]**

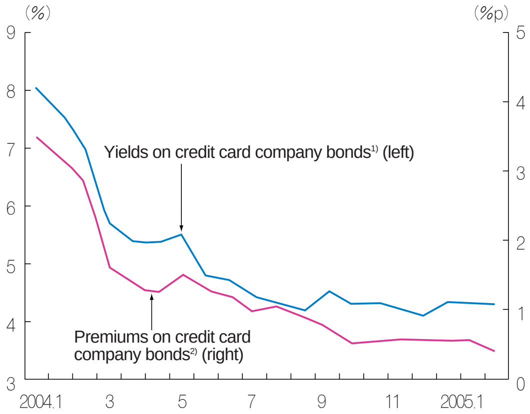
(%)

| | | 2003 | 2004 | 2005 | |
|---|---|---|---|---|---|
| | | | | Ⅰ | Ⅱ |
| Banks | Household loans | 1.8 | 1.7 | 1.8 | 1.5 |
| Credit Card Companies | Credit card subsidiaries of banks | 7.8 | 4.1 | 4.3 | 3.0 |
| | Credit card specialized companies | 14.1 | 9.0 | 8.2 | 7.6 |

Note: 1) Period-end basis.
Based on over one month in arrear.
Source: Financial Supervisory Service.

**<Figure Ⅱ-6>**

**Yields and Premiums of Credit Card Company Bonds**




Notes: 1) Samsungcard bonds (1yr.), period-end basis.
2) Spread between yields on Samsungcard bonds (1yr.) and Treasury bonds (1yr.).
Sources: Korea Bond Pricing Co., Koscom Corp.

The Bank of Korea worked toward financial market stability by maintaining a constant watch for destabilizing factors while taking prompt action against symptoms of instability.

The results of its continuous monitoring of the status of financial markets show that the overall level of risk in the financial markets is assessed as having declined. Arrears rates on banks' household loans have shown downward stability since the second half of last year with credit card arrears rates gradually declining. With these improvements and the better performance of credit card companies, secondary market yields and risk premiums on credit card company bond have declined. There has been a consequent overall improvement in the funding situation of credit card companies.

Although household loans and credit card billings have risen since April 2005, this is unlikely to bring about defaults. While the increased extension of credit mostly took the form of sales credits to good customers, cash advance services to subpar rated customers continued to decline. Household loans on credit were also mostly extended only to good customers after their income, job security and financial history had been reviewed. For housing finance loans, which are backed by housing collateral, the loan to value (LTV) ratio was limited between 40% and 60%, and therefore these loans are unlikely to go into default unless housing prices plummet. But it should be pointed out that there are concerns over a substantial increase in the volume

<Table Ⅱ-15>

**Banks' Household Loans[1]**

(trillion won)

| | 2003 | 2004 | 2005 | | | |
|---|---|---|---|---|---|---|
| | | | Ⅰ | Ⅱ | Jul. | Aug. |
| Household loans | 2.6 | 1.9 | 0.9 | 3.8 | 2.4 | 4.5 |
| (Housing collateral) | 1.8 | 1.4 | 0.8 | 2.4 | 2.1 | 2.6 |
| (Minus account loans) | 1.3 | 0.7 | 0.2 | 1.4 | 0.3 | 1.9 |

Note: 1) Based on monthly average changes.

<Table Ⅱ-16>

**Banks' Lending Attitudes[1] by Class of Borrower and the Outlook**

(%)

| | 2002 Ⅳ | 2003 Ⅳ | 2004 Ⅳ | 2005 | | |
|---|---|---|---|---|---|---|
| | | | | Ⅰ | Ⅱ | Ⅲ$^e$ |
| Total | -18 | -22 | -1 | 0 | 3 | 7 |
| Borrowers | | | | | | |
| Large enterprises | -3 | -9 | 0 | 7 | 5 | 5 |
| SMEs | 7 | -9 | -1 | 3 | 1 | 7 |
| General households | -26 | -25 | -6 | -6 | -7 | -7 |
| (House-holders) | -36 | -35 | 4 | 6 | 7 | 4 |

Note: 1) {share of "greatly moderated (increased)" respondents × 1.0
+ share of "slightly moderated (increased)" respondents × 0.5}
- {share of "greatly tightened (decreased)" respondents × 1.0
+ share of "slightly tightened (decreased)" respondents × 0.5},
the values between the maximum, 100, and the minimum, -100.

of loans backed by housing collateral because banks' balance sheets could suffer negative effects from interest rate competition among banks and the instability of the real estate market could be deepened.

Banks' lending attitudes have eased since the beginning of 2005 especially towards sound SMEs and loans backed by housing collateral. In particular, lending attitudes towards SMEs in the first quarter turned "moderate" for the first time since the fourth quarter of 2002. Of all types of financial institutions, domestic banks showed the most substantially eased lending attitudes. On the other hand, it was still difficult for SMEs and individual business owners to attract funds as the financial institutions maintained a conservative stance toward them as arrears rates continued at a high level in the case of SMEs and individual business owners.

**(Making Efforts for Financial Market Stabilization and Implementing Joint Examinations)**

In response to the surge in long-term market interest rates at the beginning of this year, the Bank of Korea conducted outright purchases of Treasury Bonds and Deposit Insurance Fund Bonds to the value of one trillion won on two occasions. It carried out a further outright purchase of Treasury Bonds worth one trillion won after market interest rates rose sharply from June in order to stabilize the bond market and secure the underlying bonds needed for RP transactions.

The Bank of Korea undertook the joint examination of four banks from January to August 2005 with the Financial Supervisory Service. The Bank sought to ensure the seamless transmission of monetary and credit policies by checking compliance with regulations and guidelines related to policies such as

**<Table Ⅱ-17>**

**Joint Examinations with the Financial Supervisory Service**

| Year | Category | Examined banks |
|---|---|---|
| 2000 | Domestic banks | Hanvit, Korea Exchange, Daegu (3) |
| 2001 | Domestic banks | Hanvit, Chohung, Seoul, Korea Exchange, Peace, Pusan, Kwangju, Kyungnam, Jeonbuk, Cheju (10) |
| | Foreign bank branches | Citi, Deutsche, HSBC (3) |
| 2002 | Domestic banks | Korea First, KorAm, Shinhan, Chohung, Kookmin, Woori, Daegu, Industrial Bank of Korea, National Federation of Fisheries Cooperative, National Agricultural Cooperative Federation (10) |
| | Foreign bank branches | Tokyo Mitsubishi, BOA, Standard Chartered (3) |
| 2003 | Domestic banks | Pusan, Korea Exchange, Korea First, Shinhan, Hana, Kwangju, Kyungnam, KDB (8) |
| | Foreign bank branches | Citi, BNP Paribas, JP Morgan Chase (3) |
| 2004 | Domestic banks | Chohung, Korea Exchange, Kookmin, KorAm, Daegu, National Agricultural Cooperative Federation, National Federation of Fisheries Cooperatives, Industrial Bank of Korea, Woori (9) |
| | Foreign bank branches | HSBC, Deutsche, UBS (3) |
| 2005 Jan.~Aug. | Domestic banks | Pusan, Hana, Jeonbuk (3) |
| | Foreign bank branches | Calyon (1) |

Aggregate Credit Ceiling Loans, reserves and the payment system. In particular, the Bank conducted jointly with the Financial Supervisory Service a partial examination to grasp the current status of housing finance loans of 17 domestic banks from July 13 to 22, with a view to stabilizing the real estate market and ensuring the smooth implementation of monetary policy.

# Ⅲ. Monetary Policy Environment and Direction for the Future

## 1. Overseas Economies

### A. Economic Growth

The world economy is expected to maintain a solidly-based recovery trend after the second half of 2005. There still remain a number of uncertainties surrounding the world economy, including the high level of oil prices, the stalled recovery of the IT industry and a possible slow-down of Chinese economic growth.

<Table Ⅲ-1>

**Outlook for World Economic Growth[1]**

(%)

| | 2004[2] | 2005e | | 2006e | |
|---|---|---|---|---|---|
| | | IMF | OECD | IMF | OECD |
| World Economy | 5.1 | 4.3 | 2.6[3] | 4.4 | 2.8[3] |
| (USA) | 4.2 | 3.6 | 3.6 | 3.6 | 3.3 |
| (China) | 9.5 | 8.5 | 9.0 | 8.0 | 9.2 |
| (Japan) | 2.7 | 0.8 | 1.5 | 1.9 | 1.7 |
| (Euro-zone) | 2.1 | 1.6 | 1.2 | 2.3 | 2.0 |

Notes: 1) Compared with the previous year.
2) Based on IMF statistics, apart from certain individual countries and the euro-zone which are based on their respective statistics.
3) Members of OECD.
Sources: IMF, World Economic Outlook, April 2005.
OECD, OECD Economic Outlook, May 2005.

The US economy is expected to continue to grow by more than 3% after the second half of this year, but high oil prices and concerns over bubbles in the housing market can place constraints on its growth. Shrugging off high oil prices and the Fed's interest rate hikes, consumer spending continues its robust pace of increase, buoyed up by improvements in the labor market and rising house prices. Facilities investment especially in the IT industry is expected to expand and housing investment is forecast to continue to grow due to low mortgage interest rates. US exports are expected to post only a slight increase because major trading counterparts have seen their economic recovery stall out.

The Chinese economy's above 8% growth is predicted to carry on through the second half of this year. As private consumption continues to expand, facilities investment especially in energy-related facilities and social infrastructure is likely to maintain its rapid growth pace. Exports are expected to maintain their convincing growth but there is the possibility of a slow-down due to trade disputes with the US and a further rise in the exchange value of the Chinese currency.

The Japanese economy is predicted to maintain its gradual recovery in the second half. The growth of facilities investment is expected to slow down given the weakening of profitability as a result of high oil prices. Private consumption, on the other hand, is forecast to accelerate due to expansion of employment, rising wages and improving consumer sentiment. Exports are also seen to grow steadily due to the strong growth of the US and China.

The euro-area economy is anticipated to show a recovery trend. Private consumption is predicted to grow as disposable income increases and facilities investment is also expected to swell due to better fund-raising conditions and the improving profitability of businesses. Also exports are likely to grow steadily, driven by the upswing of the world economy and the strengthening price competitiveness of the euro-area.

**<Table Ⅲ-2>**

**Outlook for Exchange Rates[1)]**

| | 2004 | 2005 | | | | 2006 | |
|---|---|---|---|---|---|---|---|
| | Dec. | Ⅰ | Ⅱ | Ⅲ$^e$ | Ⅳ$^e$ | Ⅰ$^e$ | Ⅱ$^e$ |
| (¥/$) | 102 | 107 | 111 | | | | |
| Morgan Stanley | | | | 108 | 112 | 110 | 115 |
| J.P. Morgan | | | | 113 | 115 | 117 | 115 |
| Goldman Sachs | | | | 110 | 102 | - | 95 |
| Citigroup | | | | 108 | 100 | - | 98 |
| Deutsche Bank | | | | 106 | 100 | - | 95 |
| Lehman Brothers | | | | 108 | 105 | 99 | 98 |
| ($/€) | 1.36 | 1.30 | 1.21 | | | | |
| Morgan Stanley | | | | 1.17 | 1.18 | 1.18 | 1.18 |
| J.P. Morgan | | | | 1.19 | 1.15 | 1.13 | 1.15 |
| Goldman Sachs | | | | 1.15 | 1.25 | - | 1.30 |
| Citigroup | | | | 1.28 | 1.28 | - | 1.33 |
| Deutsche Bank | | | | 1.23 | 1.30 | - | 1.36 |
| Lehman Brothers | | | | 1.20 | 1.25 | 1.31 | 1.33 |

Note: 1) Based on Aug. 2005.

## B. Exchange Rates and International Raw Material Prices

In international financial markets, the weakening trend of the US dollar is expected to be shown from a long-term view. This prediction is based upon the continuing huge current account deficit of the US, further gains by the chinese yuan and an upswing in the euro-zone and Japanese economies. However, given that the US economy shows relatively faster growth than that of its advanced rivals, the US dollar is anticipated to strengthen.

**<Table Ⅲ-3>**

### Outlook for Oil Prices[1)]

(US$/barrel)

| | | 2004 | 2005 | | | | |
|---|---|---|---|---|---|---|---|
| | | | 연간 | Ⅰ | Ⅱ | Ⅲ$^{e}$ | Ⅳ$^{e}$ |
| Actual value | | 38.2 | | 47.9 | 51.7 | | |
| CERA[2)] | Base | | 55.8 | | | 61.9 | 62.1 |
| | High | | 58.6 | | | 64.0 | 71.0 |
| | Low | | 52.3 | | | 57.5 | 52.5 |
| CGES[3)] | Base | | 56.7 | | | 62.1 | 65.9 |
| | High | | 57.0 | | | 62.1 | 66.9 |
| | Low | | 56.7 | | | 62.1 | 65.9 |
| Barclays Capital | | | 53.0 | | | 57.9 | 53.3 |

Notes: 1) Forecast on Aug. 2005.
Period average on basis of Brent crude.
2) High assumes supply problems in major oil producing countries.
Low assumes a large scale decrease in oil demand in the USA and China.
3) High assumes continuous world demand for oil.
Low assumes a decrease in world demand and an increase in non-OPEC supply.
Sources: CERA, CGES, Barclays Capital.

**<Table Ⅲ-4>**

### Outlook for International Raw Material Prices[1)] except for Crude Oil

(%)

| | 2003 | 2004 | 2005$^{e}$ | 2006$^{e}$ |
|---|---|---|---|---|
| IMF | 7.1 | 18.8 | 3.8 | -5.1 |
| OEF | 7.1 | 18.6 | 3.5 | -7.3 |
| EU | 6.3 | 14.4 | 1.3 | -1.1 |

Note: 1) Period average compared with the previous year.
Sources: IMF, World Economic Outlook, April 2005.
OEF, Oxford Economic Forecast, June 2005.
EU European Commission, Economic Forecast, April 2005.

The trend of high international oil prices seems set to persist. This is because it is hard to see any scope for a prompt or simple improvement in the factors that have driven up oil prices so far, including increasing demand for crude oil in the global market, OPEC's lack of further production capacity, the shortage of oil refinery facilities and the attraction of the market for speculative funds. If high oil prices discourage increasing demand for crude oil and speculative funds move out of the market, however, international oil prices will come under downward pressure.

Although there is the possibility of unstable supplies of metals, the prices of raw materials other than oil are anticipated to show a mild downward trend after the second half of 2005 owing to the slowing demand of countries around the world.

## 2. Domestic Economy

<Table Ⅲ-5>

**Outlook for GDP Growth[1)]**

(%)

| | 2004 | | | 2005 | | |
|---|---|---|---|---|---|---|
| | 1st half | 2nd half | Year | 1st half | 2nd[e] half | Year[e] |
| GDP | 5.4 | 3.9 | 4.6 | 3.0 | 4.5 | 3.8 |
| Private consumption | -0.9 | -0.1 | -0.5 | 2.1 | 3.5 | 2.7 |
| Facilites investment | 3.0 | 4.6 | 3.8 | 3.0 | 6.4 | 4.6 |
| Construction investment | 4.1 | -1.3 | 1.1 | -0.2 | 2.8 | 1.0 |
| Goods export | 29.2 | 14.0 | 21.0 | 7.3 | 9.9 | 8.7 |
| Goods import | 17.4 | 10.5 | 13.8 | 3.4 | 7.9 | 5.8 |

Note: 1) Compared with the same period of the previous year.

In the second half of 2005, GDP growth is forecast to rise to around mid-4 percent level from the 3.0% of the first half as private consumption shows a more clearly-marked recovery. Unless external factors such as international oil prices defy expectations by worsening greatly, the growth rate in the fourth quarter is expected to accelerate above the mid-4 percent level.

Private consumption is forecast to pick up more rapidly than in the first half. The labor market especially for employment in services is gradually recovering and the income of SOHO business is expected to show mild growth driven by the improved domestic spending. Since the adjustment of household balance sheets has progressed to some degree, the problem of the constraints on household liquidity is likely to be resolved. In addition, the five-day workweek system that was adopted in July 2005 is anticipated to encourage domestic consumption. But structural problems such as the ageing of the population, the increase of savings for old age in view of employment instability and polarization of the income-distribution structure are likely to stand in the way of a rapid recovery of private consumption.

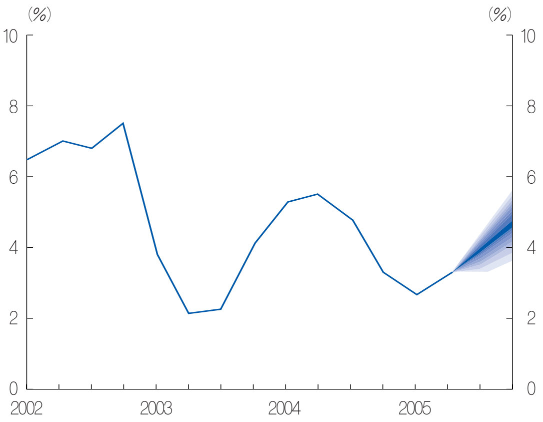
Facilities investment is seen to stage a mild recovery. Pressures for an adjustment of facilities investment especially in steel; semiconductors; audio, video & communications; and automobiles sectors are growing and corporate sentiment for investment is expected to improve along with the revival of private consumption. Also investment in transportation equipment is seen to recover and investment in machinery, especially imported machinery, is expected to show a mild expansion driven by increasing exports of IT products.

Construction investment is anticipated to pull out of the recession in the first half. Leading indicators such as order-books show signs of recovery and more rental apartments are to be constructed. Apart from the comprehensive investment plan announced by the government last year (2 trillion won in total), public spending of 4.4 trillion won will be implemented in the latter half for projects by public enterprises. The government's package of measures on August 31 to stabilize the heated property market, however, is expected to constrain the recovery of construction investment in the short term.

The robust upward trend of exports will be maintained given the continued buoyancy of the US and Chinese economies in the latter half and the possibility of the stability of the US dollar-Korean won exchange rate. Their year-on-year rate of increase, though, is forecast to fall because of a base-period effect brought about by their sharp rise in the previous year.

**<Figure Ⅲ-1>**

**GDP Growth[1] Projection**




Note: 1) Compared with the same period of the previous year.

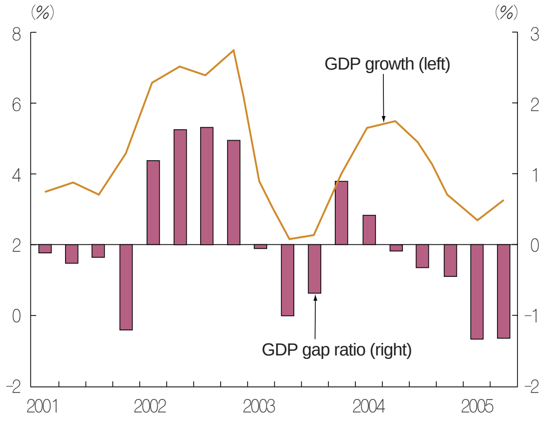
The analysis of anticipated GDP growth in the fan chart (Ⅲ-1) indicates that, as of August 2005, the possibility of GDP growth of above 4.0% in the latter half of the year is 60% and that of its falling to within a range of 3.0% to 4.0% is 38%.

The current account surplus is expected to continue, but to narrow further. This is because the scale of the goods account surplus is seen to decrease substantially due to the swelling imports resulting from high international oil prices that will offset the robust increase in exports. The huge deficit on the service, income and current transfers account is anticipated to continue.

Meanwhile, labor market conditions are likely to improve gradually as recovering domestic consumption brings down the unemployment rate and more people are hired, especially by businesses in the service industry.

**<Figure Ⅲ-2>**

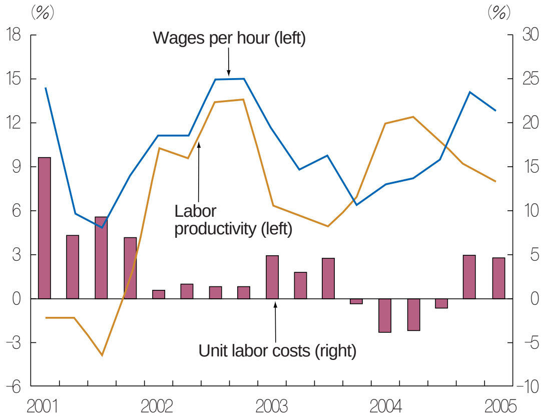
**GDP Growth[1] and GDP Gap[2]**




Notes: 1) Compared with the same period of the previous year.
2) Potential GDP was estimated by trend extraction of the production function.

**<Figure Ⅲ-3>**

**Wages and Unit Labor Costs in Manufacturing[1]**




Note: 1) Compared with the same period of the previous year.
Source : The Korean Productivity Center.

## 3. Prices

Inflation is forecast to hold steady in the latter half of 2005. That said, there are still not insubstantial potentially destabilizing factors. These included the unexpected persistence of high international oil price and concerns that the existence of ample market liquidity could put pressure for inflation in the process of economic recovery.

On the demand side, it is estimated that the GDP gap ratio will continue negative in the latter half. Its size, though, will be smaller as domestic demand improves. By sector, the growth rates of charges for personal services such as eating-out are anticipated to be lower than in the previous year. Those of the prices of agricultural products and public utility charges are seen to be lowered by a base-period effect brought about by their large increase of the previous year.

The upward pressures on the cost side are expected to be relatively mild although soaring oil prices could be a negative factor. Prices of raw materials other than oil have been stable since the second quarter this year and the won's exchange rate against the US dollar is also seen to continue stable. Even though there are plans to raise some charges for public services such as taxi cab fares, unit labor costs are forecast to grow more slowly than in the first half. Property prices, which recorded large increases in the first half, are anticipated to show a downward trend due to factors such as the comprehensive government measure of August 31 to stabilize the property market.

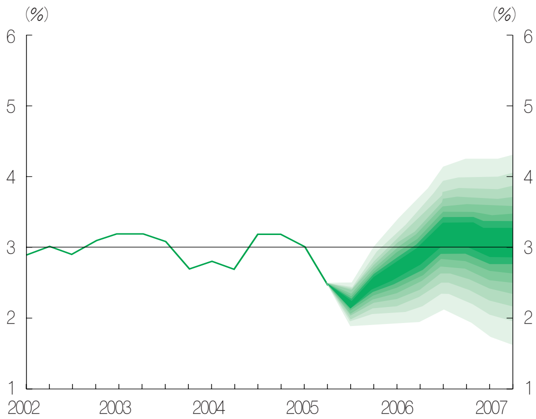
Accordingly, the rate of year-on-year increase in consumer price inflation in the second half is estimated to be lower than the 3.1% of the first half. In the third quarter, it is likely to register around the mid-2 percent due to a base-period effect brought about by the high increase of the previous period, but it will pick up to almost 3.0% in the fourth quarter.

The rate of core inflation is expected to hold stable at 2.5%, the lower bound of the target range in the latter half of the year. While demand pressures remain weak, upward pressures on the cost side are not forecast to be high with the exception of those for petroleum products, which are heavily influenced by changes in international oil prices. By period, the rate is forecast to drop substantially below the lower bound of the target range in the third quarter but like the CPI it will pick up a little bit in the fourth quarter.

Examining the analysis by means of a fan chart of the future course of inflation, given that the call rate target remains at its current level, the probability of the rate of core inflation remaining within the target range of 2.5 to 3.5% for a year is given as 51% and that for it slipping below the lower bound of the large range as 49%, which is quite high.

**<Figure Ⅲ-4>**

**Core Inflation[1] Projection**




Note: 1) Compared with the same period of the previous year.

The analysis of the core inflation rate for the next two years indicates that the probability of the rate of core inflation remaining within its target range of 2.5~3.5% is given as 73% and that of its slipping below the lower bound of the target range as 24%. Given that the average core inflation rate from January 2004 to August 2005 was 2.8%, the target rate for 2004 to 2006 is likely to be met.

There are, however, latent factors that could cause price instability. On the cost side, oil prices could stay at a high level for a long while if demand for oil from countries such as the US and China continues to rise or problems crop up in major oil-producing countries, interrupting oil supplies. On the demand side, the ample market liquidity could put upward pressures on prices in the course of economic recovery.

## 4. Future Monetary Policy Direction

The Bank of Korea's monetary policy will be directed in such a way as to pay attention to the state of business activity while maintaining price stability. The Bank plans to take preemptive measures in case that latent upward pressures on prices threaten to become substantiated in the course of the economic recovery. In this connection, it will keep a close watch on business conditions and price movements.

Given the large number of uncertainties surrounding the domestic and international economies, the Bank of Korea will carefully monitor changes in the policy environment and implement monetary policy to minimize the consequent side-effects.

In order to heighten the effectiveness of monetary policy, the Bank will continue to work toward a harmonious policy-mix with fiscal, foreign exchange and financial supervisory policy.

<Box Ⅲ-1>

## Changes in Consumption Structure and Future Direction

Household consumption in Korea has been a major factor detracting from the economic recovery as its depressed state since the second quarter of 2003 has become deeply entrenched. This was largely because a deteriorating labor market, heavy debts and the increasing burden of supporting the social safety net discouraged the growth of household incomes. Changes in consumption structure are also seen to have played a considerable role.

**GDP Growth and Household Consumption Growth**

(%)

| | 1990s | 2000 | 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|---|---|
| ■ GDP growth rate | 6.3 | 8.5 | 3.8 | 7.0 | 3.1 | 4.6 |
| ■ GNI growth rate | 5.9 | 5.5 | 2.8 | 7.0 | 1.9 | 3.8 |
| ■ Household consumption growth | 5.7 | 8.6 | 4.9 | 7.9 | -1.3 | -0.5 |
| (Contribution to growth, %p) | (3.2) | (4.5) | (2.6) | (4.2) | (-0.7) | (-0.2) |

As society ages rapidly, job security is undermined and confidence in the National Pension Fund weakens, people feel insecure about life after retirement. Therefore, people who are in their 50s or older tend to save more instead of spending. Since Korea is ageing more rapidly than other countries, if people continue to lose confidence in arrangements such as the National Pension Fund, younger people in thier 20s, 30s and 40s are likely to follow suit.

**Average Consumption Ratio by Age-group[1)]**

(%)

| Age-group | 2000 | 2004 |
|---|---|---|
| ■ 35 ~ 39 | 75.6 | 74.0 |
| ■ 40 ~ 44 | 75.9 | 77.7 |
| ■ 45 ~ 49 | 78.5 | 79.3 |
| ■ 50 ~ 54 | 82.9 | 78.1 |
| ■ 55 or older | 76.1 | 69.4 |

Note: 1) Based on age of heads of households.
Source: Korea National Statistical Office.

With the greatly increased openness and liberalization of the economy along with rapid developments in information technology, it is now easier to buy foreign products and services. While domestic consumption grew 2.7% a year on average from 2000 to 2004, overseas consumption soared 18.2% a year during the same period. This is largely to the fact that domestic industries failed to gain a competitive edge and to meet the needs of domestic consumers, especially in education, tourism and medical services. In addition, the size of the middle income group shrank and that of the higher income group and the low income group increased as the income distribution structure deteriorated after the financial crisis. Therefore, a polarization of consumption has become clearly evident. The growing number of higher income earners leads to increasing demand for high-end goods and services overseas while the growth of the number of low-income households detracts from the growth of overall domestic consumption.

Such trends in the consumption structure are expected to be long-lasting. If we fail to deal with these changes, the virtuous cycle of “growing consumption → increasing production, employment and income → more consumption” will be undermined. If this happens, the domestic economy will be negatively affected as the growth potential weakens and dependence on other countries deepens. Therefore, we need to create new demand by enhancing the competitiveness of the educational, medical services and tourism sectors and fostering markets with great potential such as the IT industry in order to meet domestically the demand that now exists for overseas goods and services. In addition, we should enhance the social welfare system to relieve people’s concerns about their life after retirement and spur on our efforts to come up with better policies to restore the purchasing power of low income groups, who are suffering from the widening gap between the rich and the poor, snowballing household debts and credit blacklisting.

**<Box Ⅲ-2>**

## Major Details of the Comprehensive Real Estate Policy Package & Its Impact on the Domestic Economy

The Korea government unveiled a comprehensive real estate policy package on August 31, 2005 to curb the instability of the real estate market and bring about its long-term stability. The policy package aims to impose taxes more stringently, limit housing finance loans and supply more housing.

More specifically, the housing-related tax system will be streamlined. The average effective tax rate for people who are required to pay the comprehensive real estate holding tax will be adjusted to 1% by 2009 from the current 0.15%. But households owning houses worth less than 600 million won in total at the official valuation (750 million won at market price) will be exempted from the tax. In addition, transfer income tax based on actual prices will be imposed on households with two or more houses from 2006 and on all householders from 2007. The transfer income tax rates for households with two or more houses will be raised to 50% in 2007 from the current 9 to 36%. But the rates of acquisition tax and registration tax for housing will be lowered by 50 basis points from 2006. Besides this, people from the same household in a designated speculation-prone areas will be unable to take out loans backed by housing collateral in those areas (effective from September 5 2005). In a further move, an additional 3 million pyong of public land a year (15 million pyong over five years) will be provided for public housing and re-developing existing towns. The prices of all apartments built on such public land will be linked to their cost.

Regarding the land market, applicants for land purchases are now required to submit a funding plan and the required holding period is extended from 6 months~1 year to 2~5 years. At the same time, a charge for development will be imposed on land development. For redevelopment and reconstruction, infrastructure charges will be imposed. The average effective tax rate on land owned for the non-business purposes will be raised to 1% by 2009 and a transfer income tax based on the market price will be imposed from 2006 on sellers of land, and fields for growing agricultural products who are not residents of the area concerned. From 2007, sales of all land and fields will be subject to taxation based on actual prices received.

**Comprehensive Real Estate Holding Tax Adjustment Plan**

(%)

| | Housing | Land |
|---|---|---|
| ■ Increase in the tax base | Currently 50% of official valuation → 70% ('06) → 80% ('07) → 90% ('08) → 100% ('09) | Same as housing |
| ■ Adjustment of the standard amount for taxation | Larger than 900 mil. won per person → Larger than 600 mil. won per household | Larger than 600 mil. won per person → Larger than 300 mil. won per household |
| ■ Tax cap | 1.5 times of the previous year → 3 times | Same as housing |

As a result of the new reform policy, housing prices especially those of apartments to be rebuilt in Southern Seoul are expected to fall for a while. Next year, prices will fall even further as households with more than one house try to sell excess housing units. Land prices are also anticipated to fall except for land in areas slated for development. Falling real estate prices will negatively affect consumption and construction investment in the short term, which will lead to lower growth rates. But in the medium and long term, stable inflation will drive up consumption, which will result in a higher GDP growth rate. In particular, more stringent taxation and stable property prices will encourage resources to seek out more productive sectors and induce many positive effects such as improving housing and the investment environment, narrowing the gap between the rich and poor and laying the groundwork for social cohesion. Therefore, they are expected to contribute to heightening the growth potential of the domestic economy. On the financial side, funds concentrated in the property market will flow into more productive areas through the stock market and bring about positive effects such as lifting stock prices and slowing increases in interest rates.

Analysis of the impact of the real estate policy package on the real economy using the Bank of Korea's macroeconomic model (BOK 04) indicates that if housing prices fall 3% by the end of 2006 (10% for Kangnam and 5% for Greater Seoul) GDP growth rates will decrease 0.02 percentage point in the latter half of 2005 and 0.11 percentage point throughout 2006. But from 2007, the growth rate is expected to rise slightly. Even if housing prices fall 7% (20% for Kangnam and 10% for Greater Seoul), only a 0.04 percentage point decline in the GDP growth rate is forecast in the latter half of 2005 and 0.11 percentage point throughout 2006, which is unlikely to detract seriously from the economic recovery.

**Economic Consequences of Falling Housing Prices (Assuming 3% decrease)**

(%)

| | 1st year | 2nd year | 3rd year | 4th year |
|---|---|---|---|---|
| ■ GDP | -0.12 | -0.03 | 0.00 | 0.01 |
| Private consumption | -0.30 | 0.01 | 0.06 | 0.07 |
| Construction investment | -0.29 | -0.47 | -0.44 | -0.43 |
| ■ Consumer prices | -0.08 | -0.06 | 0.00 | 0.00 |

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