

■ South Korea

UOB Economics Projections	2007	2008	2009F	2010F
GDP	5.1	2.2	-1.0	4.5
CPI (average, y/y)	2.5	4.7	3.0	3.1
Unemployment (4Q avg)	3.1	3.3	3.7	3.5
Current account (% of GDP)	0.6	-0.7	4.2	1.3
Fiscal balance (FY, % of GDP)	3.5	1.2	-2.1	-0.8

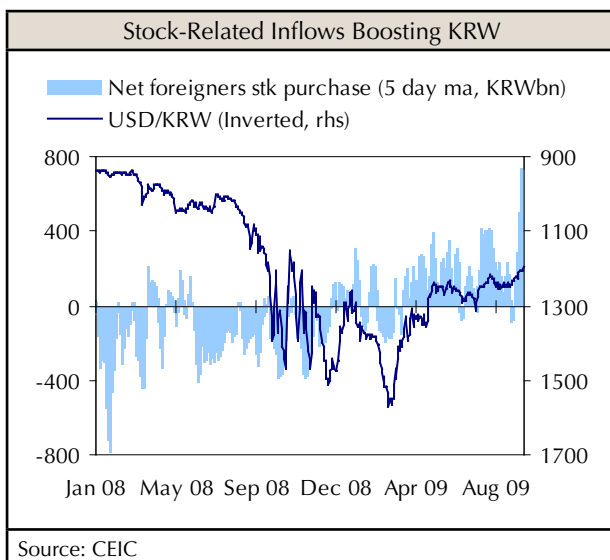
USD/KRW took out the key 1,200 support in September on the back of more buoyant market conditions. A sustained current account surplus will provide the basis for the KRW strength in 4Q although the BoK's interventionist stance suggests further USD/KRW descent from here will be slow. KRW is likely to hold its ground around 1,180/USD by the end of the year.

Manageable inflation risk and weak growth in the near-term point to stable interest rates but the timing for monetary tightening in South Korea appears increasingly tied to concerns in the property market. We are still maintaining our forecast for the BoK to start normalising interest rates in 2Q10 with total hikes totalling around 125bps next year although the risk has apparently shifted towards a sooner rate hike.

We have upgraded our forecast for South Korea's growth rate to -1.0% for this year and 4.5% next year. The underlying positive momentum in growth is expected to continue into 2H09 although the pace could slow as the effect from the fiscal stimulus wanes. The economy is likely to remain in y/y contraction in 3Q (albeit a smaller one) before rebounding into the positive territory in the last quarter of the year, helped by basis effect.

USD/KRW took out the key 1,200 support in September on the back of more buoyant market conditions. So far, the KRW has surged more than 30% from its low of 1,570/USD earlier this year. A sustained current account surplus will provide the basis for the KRW strength in 4Q although the BoK's interventionist stance suggests further USD/KRW descent from here will be slow. The BoK is likely to be mindful of more KRW appreciation given still

sluggish exports. The country recorded a current account surplus of US\$28.15bn in the first eight months of the year, improving sharply from a deficit of US\$12.58bn in the same period a year ago. We expect the current account surplus in 4Q09 to remain strong given that the trade surplus is likely to match the earlier levels. As such, KRW is likely to hold its ground around 1,180/USD by the end of the year.



BoK Signalled Possibility to Hike Rate Soon

The BoK kept its benchmark base rate unchanged at 2.0% for the seventh consecutive meeting in September, citing uncertainty in the economic growth trajectory as the key motivation to maintain the loose monetary policy although "mortgage loans continued their large-scale expansion". Nonetheless, the BoK's tone has turned surprisingly hawkish with governor Lee Seong-tae indicating that a near-term rate hike is possible if property prices continue to run up. Even then, he said this will be in line with an accommodative policy stance – true actually since the BoK was the most aggressive central bank in Asia to have cut its benchmark rate by 325bps since the global downturn. The BoK has reportedly said monetary policy tightening could be used in addition to the regulatory measures to curb the 'bubble' in the real

▪ South Korea

estate market. Central to the concern is that recent more stringent limits on bank mortgage lending could still fail to rein in the greater-than-expected increase in property prices and transactions in the country even as economic growth has yet to stabilise.

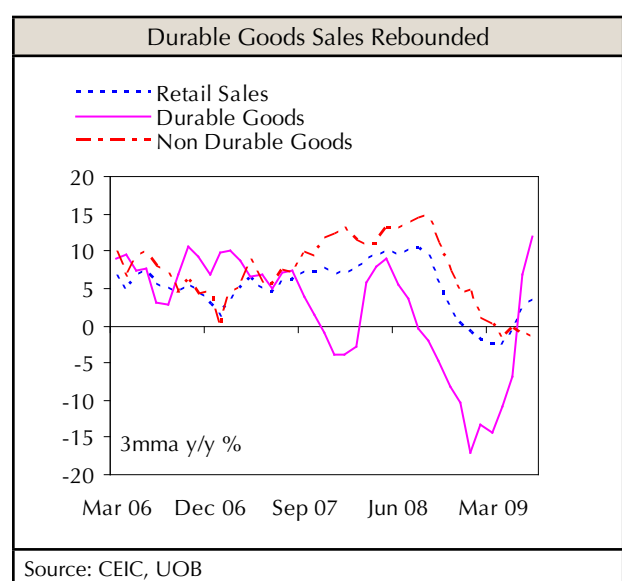
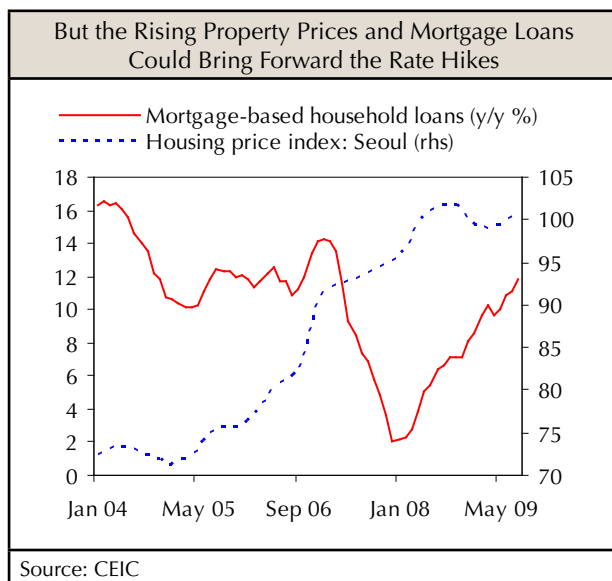
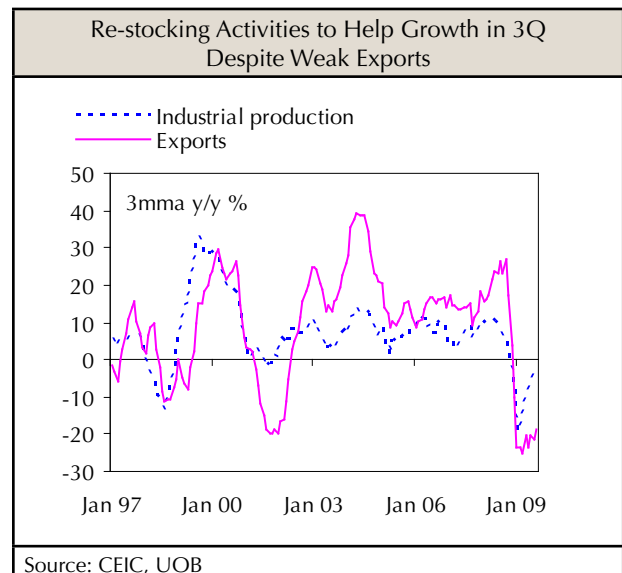
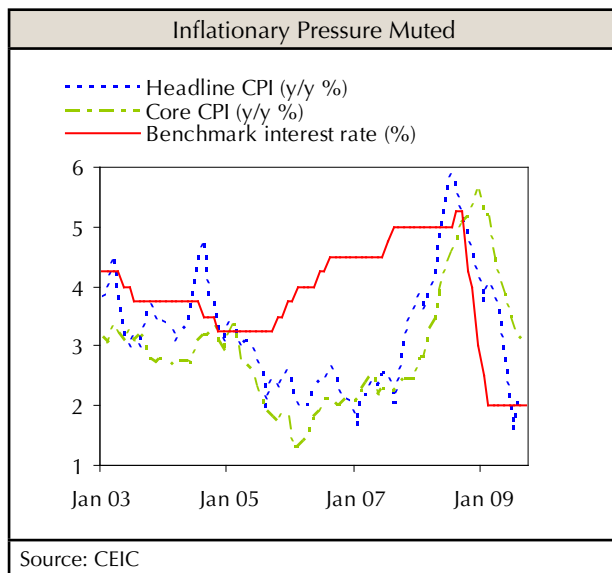
Property 'bubble' is a Concern

The property price index for Seoul has been rising on a m/m basis since April this year and in August, the index was just 0.9% below the peak in September 2008. Further indicating the rebound in the property market, apartment transaction volume in July has risen to levels last seen in early 2008. Household mortgage loans rose by 11.9% y/y in August, the third consecutive month of double-digit growth and the fastest since March 2007.

To keep a lid on the real estate market, the government has recently expanded the debt-to-income ratio regulation to the Seoul metropolitan area for mortgage loans exceeding 50 million won, which requires that the total mortgage cannot exceed 50% of a borrower's annual income in Seoul and 60% of income in the Incheon and Gyeonggi Province. The regulators are now watching mortgage loans extended by non-banking institutions which are not subject to the stricter regulation. We foresee more measures to control the real estate market in the coming months before the BoK jumps onto the monetary tightening bandwagon by around 2Q10.

But Inflation Risks are Fairly Contained

On inflation, the risk is still fairly contained with headline



▪ South Korea

inflation likely to average around 2.0%/y/y in 3Q09 due to lack of demand-pull pressure. We expect the inflation rate to rise to an average of 3.1%/y/y in 4Q09 and 1H10, partly driven by a low base effect. This is still within the BoK's inflation target of 2.5%-3.5%.

Manageable inflation risk and weak growth in the near-term point to stable interest rates but the timing for monetary tightening in South Korea appears increasingly tied to concerns in the property market. We are still maintaining our forecast for the BoK to start normalising interest rates in 2Q10 with total hikes totalling around 125bps next year although the risk has apparently shifted towards a sooner rate hike. The country's y/y growth is likely to rebound into the positive territory only in 4Q09. This suggests that the BoK would be more comfortable normalising interest rates in early 2Q10.

Improving Growth Outlook

South Korea's growth momentum strengthened in 2Q09 following the sharp 5.1%q/q drop in 4Q08. It was among the few countries showing consecutive q/q growth in the first two quarters of the year. On a y/y basis, the pace of decline moderated with the economy contracting by 2.2% in the quarter. The key driver was government spending even as private consumption showed signs of bottoming-out. Construction fixed investment also contributed to growth in 2Q due to the rebound in the real estate market activities despite the continued weakness in machinery investment.

Going forward, consumer spending is likely to continue improving in 2H09 in line with the rebound in consumer sentiment index in the country and the employment situation. The unemployment rate has eased to 3.8% in August after peaking at 4.0% in June. Furthermore, recent data also suggests that re-stocking activities have begun as industrial production rebounded despite the lacklustre external demand. The country's industrial production growth turned into the positive territory by July on signs of inventory rebuilding in the automobile and electronics sectors although exports were still contracting 20.9% y/y in August, not much improvement compared with 22.6%/y/y contraction in the first seven months of the year. As such, we are likely to see inventory building contributing to overall growth in 3Q after it fell for three consecutive quarters since 4Q08. In addition, given the low base in 4Q08, we expect exports to turn in positive growth by the last two months of the year. This should provide some boost to the GDP in 4Q09.

We have upgraded our forecast for South Korea's growth rate to -1.0% for this year and 4.5% next year. The underlying positive momentum in growth is expected to continue into 2H09 although the pace could slow as the effect from the fiscal stimulus wanes. This is particularly so in 2010 given the projected 3.3% cut in the government spending. The economy is likely to remain in y/y contraction in 3Q (albeit a smaller one) before rebounding into the positive territory in the last quarter of the year, helped by basis effect.

2Q09 GDP: Outlook has Continued to Improve							
	2008	2Q08	3Q08	4Q08	1Q09	2Q09	2Q09
	y/y % change						ppt cont
Real GDP	2.2	4.3	3.1	-3.4	-4.2	-2.2	-2.2
Final Consumption	1.6	2.6	2.0	-1.9	-2.0	0.9	0.6
Private Consumption	0.9	2.3	1.4	-3.7	-4.4	-0.8	-0.4
Government Consumption	4.2	4.0	4.5	4.7	7.3	7.1	1.0
GFCF	-1.7	0.6	1.8	-7.3	-8.1	-2.7	-0.7
Construction	-2.1	-0.3	0.2	-5.6	1.6	3.7	0.6
Facilities Investment	-2.0	1.1	4.3	-14.0	-23.5	-15.9	-1.6
Change in Stocks (% of GDP)	1.5	2.6	2.1	-1.3	-1.4	-4.0	-6.4
Net Exports	30.6	47.2	12.2	33.6	104.5	93.1	4.0
Exports of G&S	5.7	11.5	9.3	-6.9	-10.6	-3.9	-1.8
Imports of G&S	3.7	8.9	9.0	-11.2	-18.2	-13.7	-5.8

Source: CEIC, UOB