

Economic

Credit Agencies

Moody's: A3

S&P: A

Fitch: A+

Nominal GDP (USD, 2006)

USD888bn

Population (2006):

48.7 million

Total Trade / GDP:

71.4%

Currency:

Korean won (KRW)

Exchange regime:

Independently floating

Merchandise imports from Canada (2006):

CAD 3,188m

Main sources of Foreign Exchange (excl. FDI):

Semiconductors (10%)

Passenger cars (9%)

Largest Merchandise Trading Partner:

China (21%)

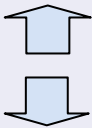
United States (13%)

Main imports:

Machinery and equipment (29%)

Fuels (27%)

Risks to the Outlook



Continued strong growth in China and US
Steep appreciation of House-prices and the won

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Ala Kassay

akassy@edc.ca

Market Spotlight: Subsequent to the slow growth apparent in the second half of 2006, Korea appears set to display stronger growth this year. Supported by strong gains in domestic demand, led by investments, economic growth came in above expectations in Q1/07. This transition from foreign to domestically-led growth is timely, as waning foreign demand will apply downward pressure on export growth as the year unfolds.

Recent Economic Developments: Real GDP posted 4% y/y growth in Q1/07, the same as the previous quarter in 2006. After a poor showing the last few years, domestic demand has strengthened markedly with a rise of 4.03%/y/y in 2006 and is on pace to surpass this gain in 2007. Within the first three months of the year consumption expenditure and fixed investment gained by a robust 4.3%/y/y and impressive 7%/y/y. Bolstered by a rise in disposable income and stock market earnings consumer sentiment on June/07 reached 101.5, following a five month rally in confidence gains, suggesting that domestic demand will be a significant driver of growth this year. This optimism, however, has also generated strength from the recent appreciation in house prices, augmenting wealth perception, which in Feb/07 hit 12%/y/y. Although house prices have decelerated since then, the Bank of Korea (BoK) maintains a close watch on property asset prices.

Monetary Policy: Since early September 2005, the Central Bank of Korea has tightened monetary policy, lifting the overnight rate by 125bps by August 2006 to 4.50%. There it has remained for 11 consecutive months until the recent 25bps rise to 4.75%, despite inflation being below the BoK target of 2.5%-3% and slowing lending growth. Inflation remains benign as a strong won has put a lid on import price pressures and the threat of outsourcing has kept firms from raising prices. Headline CPI came in at 2.5%/y/y in June/07 while domestic credit in Q1/07 grew at the slowest pace in two years at .7%q/q. There is a cost, however, with every benefit as the won continues to strengthen against the dollar recently hitting a record high of 912.75/US\$. This, in turn, has raised concerns to whether the currency is overvalued. Given that merchandise imports are expected to pick up and that the services deficit will remain in the red during H2, as a result of continued growth in outbound tourism, won appreciation is likely to moderate over the remainder of the year.

Fiscal Policy: Korea's fiscal stance looks to be stimulative this year – indeed, the authorities are forecasting a budget deficit of 1.5% with an increase in government outlay of 6.4%. In an attempt to frontload public expenditures in the first half of 2007, government receipts have grown at an average of 79% m/m. Revenue growth, likewise, has remained robust since January.

External Accounts: Despite weakening US demand, Korean exports remain resilient with double digit growth rates, recently hitting a record high of \$178.1 billion after advancing by an unexpected 16%/y/y in June. This momentum has been fuelled by strong external demand for autos, semiconductors and ships. However, the strong won has cut into trade revenues as it returns to pre-crisis levels. Nonetheless, accelerating exports have helped to augment foreign reserves, keeping import cover high at an estimated 7.4 months. Moreover, Korea's external debt has increased of late but remains sustainable.

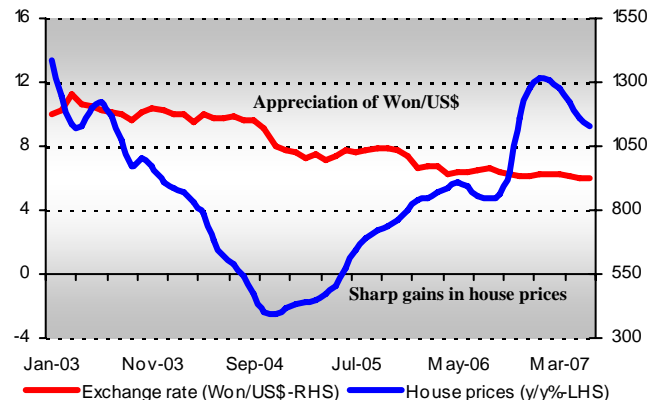
Outlook: Given that exports are expected to moderate as US demand wanes; the current account surplus to shrink as the service deficit goes deeper in the red; and the won to moderate against the dollar but remain strong, we forecast that real GDP growth will decline to 4.3% in 2007. Though, what concerns us most is the weakness in imports amid strong domestic demand and what it may imply about the sustainability of the robust growth seen in consumer spending during the first half of the year. Hence, we await the forthcoming release of the national accounts with great anticipation. Overall, Korea's close trade ties with China should keep exports relatively strong as they face sluggish global economic growth in 2007.

Economic Indicators

	02-06 avg.	2006	2007(f)	2008(f)
GDP (% growth, real)	4.8	5.0	4.3	4.7
Inflation (% , year-end)	3.0	2.2	2.4	2.5
Fiscal Balance (% of GDP)	1.2	0.4	0.6	0.6
Exports (BoP, % change, goods)	17.0	14.8	9.5	7.2
Imports (BoP, % change, goods)	17.0	18.4	11.9	10.1
Current Account (% of GDP)	2.0	0.7	0.2	-0.7
Reserves (month of imports)	7.6	7.1	6.7	6.5
External Debt (% of GDP)	21.0	20.4	20.8	19.8
Debt Service ratio	5.9	5.4	5.4	5.3
Currency (per USD, year-end)	1072.3	935.9	890.0	839.0

Source: EIU, EDC Economics

BoK watch: House Prices and FX Rate



Source: BOK, Bloomberg

Political

Political Structure

Presidential government with a Prime Minister and State Council (cabinet).

President

Roh Moo-hyun

Prime Minister

Han Myeong-sook

National Legislature

Kuk Hoe (National Assembly)

Major Parties

- Uri Party
- Grand National Party (GNP)
- Democratic Labour party (DLP)
- Millennium Democratic Party (MDP)

Last Elections

- Presidential: December 19, 2002
- Legislative: April 15, 2004

Next Elections

- Presidential: December 2007
- Legislative: April 2008

Press Freedom Survey:

- 2006 Score: 30 (Free) freedomhouse.org

Control of Corruption Index:

- 2005 Score: +0.47 (-2.5: Worst; +2.5: Best) worldbank.org

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Peter Whelan
pwhelan@edc.ca

General Political Environment:

South Korea (Republic of Korea – ROC) is a maturing democracy. Since the country's return to civilian rule in 1987, competitive electoral politics have become firmly entrenched. However, government institutions remain relatively weak and politics is still characterised by regionalism, patronage and personalities.

Roh Moo hyun (then of the MDP) narrowly won the 2002 election. Roh was elected on a platform that included anti-corruption, corporate reform and engagement with North Korea (DPRK). Roh is generally viewed as having been an ineffective leader. His backtracking on progressive social policies has disappointed younger voters while confrontational tactics have alienated much of the population.

Roh's widespread unpopularity has greatly weakened the Uri party, which he joined after leaving the MDP in 2003. In fact, defections from the party in early 2007 have left the opposition GNP with more seats in parliament than Uri. Having served for one term, Roh is constitutionally barred from standing for reelection. In any event, given the extremely low support enjoyed by Roh and Uri, it is expected that the conservative GNP will fare well in the upcoming legislative and presidential elections.

South Korea is caught in the middle of the standoff over North Korea's nuclear weapons programme and the country is a participant in the six-party talks aimed at finding a resolution to the issue. An agreement was reached in February 2007 calling for North Korea to dismantle components of its nuclear programme in return for oil shipments from the members of the six-party talks. In spite of this progress, all parties have yet to live up to their commitments under the agreement.

The ROK is generally perceived to have taken a more conciliatory stance toward North Korea than the other six-party partners (particularly the U.S. and Japan). This position has caused tension between Seoul and Washington, particularly since the nuclear test undertaken by the DPRK in October 2006.

Investment Environment:

While South Korea is officially open to foreign direct investment, the population's perception of it tends to be negative. The Government historically kept a tight rein on how foreigners participated in the economy.

Many restrictive regulations were relaxed in the wake of the Asian financial crisis but the recent passage of laws limiting the number of foreign directors at Korean banks and foreign firms' ability to benefit from double taxation treaties indicates a trend back toward nationalistic regulation.

Accounting and regulatory systems are not up to developed market standards and interpretation of regulations can be inconsistent. Domestic commercial arbitration is available to foreign investors. Judgements of foreign courts are not enforceable.

In February 2007, the chairman of Hyundai Motor, Chung Mong-koo, was sentenced to a three-year prison term on embezzlement charges. He was subsequently released on bail and is appealing the ruling. This court ruling reflects the clampdown on *chaebol* (conglomerates) undertaken by the government in recent years taking aim at poor corporate governance and corruption. However, the government has been reluctant to fully challenge the influential conglomerates and recent legislation has undone some of the progress made in cleaning up their activities.

Political Violence:

The main security threat to the ROK comes from North Korea. The border between the countries is the most heavily militarized in the world. South Korea would almost certainly suffer massive casualties in the highly unlikely event that the DPRK nuclear crisis escalated into a military conflict.

Politically-motivated violence is no longer a serious problem in South Korea. However, protests by farmers, organized labour and opponents of the U.S. military presence (32,500 troops) in the ROK have the potential to damage property.

Political Outlook

Roh Moo-hyun has been rendered a 'lame duck' as a result of the opposition's landslide victories in by-elections in 2005, local elections in 2006 and defections in 2007. As such, he will find it almost impossible to advance his policy priorities during the rest of his term. The conservative GNP and its leader, Park Geun-hye, have emerged as clear favourites in the 2007 presidential and 2008 legislative elections while the Uri Party is now in complete disarray. As a result, South Korea's shift back to the right seems likely to continue.