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September 13, 2007

**The Acting Chair's Summing Up
Republic of Korea—2007 Article IV Consultation
Executive Board Meeting 07/79
September 12, 2007**

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the strong recovery that Korea has made since the Asian crisis and its success in adapting to the changing global landscape, which have been supported by the authorities' forward-looking and prudent economic policies. In recent years, growth has been buoyed by strong exports and resilience in domestic demand. Notwithstanding some increase in volatility in the Korean equity market, Korea has thus far weathered well the ongoing turbulence in the global financial system.

Directors observed that Korea's near-term outlook is favorable, with growth likely to remain robust and inflation contained. However, they cautioned that the risks in the global environment have increased, as indicated by recent world market developments.

Directors considered that, with inflation pressures well contained, there is scope for loosening monetary policy were downside risks to materialize. They encouraged the authorities to further develop the money market to strengthen the monetary transmission mechanism, which would help limit further recourse to reserve requirements, and they supported efforts to refine the inflation targeting framework. Directors saw less room for maneuver on the fiscal side, in light of Korea's considerable medium-term fiscal challenges. The broadly neutral fiscal stance therefore remains appropriate.

Directors agreed that the won appears broadly appropriately valued. External competitiveness remains strong despite the large appreciation of the won vis-à-vis most major currencies over the last few years. Going forward, Directors agreed that the exchange rate should continue to be market determined, with intervention in the foreign exchange market limited to smoothing volatility.

Directors welcomed the progress that has been made in recent years in strengthening Korea's financial sector, as reflected in improvements in financial soundness indicators, risk assessment practices, and credit information. As a result of these reforms, vulnerabilities are low and the financial sector appears to be well-placed to deal with shocks. However, there remain pockets of domestic risk that bear close watch. A decline in housing prices could affect consumption, in particular as a sizable share of households still hold short-term bullet-type mortgages. Also, notwithstanding recent improvements in risk management practices at

banks, the recent rapid growth in lending to small- and medium-size enterprises could lead to an increase in nonperforming loans, particularly if the economy were to slow. Directors saw the further development of the mortgage market and continued upgrading of banks' risk assessment models, in line with the introduction of Basel II, as effective ways of mitigating these risks.

Directors considered that further financial sector development would support Korea's economic performance over the longer term, as well as assist in dealing with potentially volatile capital flows. In this respect, they welcomed the recent passage of the Capital Market Consolidation Act, which should contribute significantly to the emergence of strong investment banks and a resilient capital market.

Directors observed that Korea will confront the burden of an aging society in coming decades, as have many industrial countries. Addressing the resulting fiscal pressures will require action on a number of fronts, notably increasing tax revenues through base broadening and improved tax administration, further pension reform, and reorientation of public spending toward high-priority areas. Directors appreciated the authorities' ongoing efforts to address these challenges, but stressed that comprehensive and timely reforms would ease adjustment. At the same time, they commended the authorities' efforts to inform the public of long-term fiscal pressures through their Vision 2030 initiative. Some called for the regular publication of a comprehensive long-term fiscal report.

Directors noted that Korea's manufacturers are likely to face increasingly intense competition from lower-wage countries, while services sector productivity remains relatively low. To maintain competitiveness in global markets and sustain high rates of growth over the long term, Directors encouraged the authorities to continue taking steps to liberalize the services sector, enhance labor market flexibility, and improve the investment climate, notably for foreign direct investment. They supported the authorities' intention to use free trade agreements to help achieve some of these goals, while remaining committed to multilateral trade liberalization initiatives.

It is expected that the next Article IV consultation with the Republic of Korea will be held on the standard 12-month cycle.