FOR AGENDA

SM/08/264
Correction 1

September 4, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Republic of Korea—Staff Report for the 2008 Article IV Consultation**

The attached corrections to SM/08/264 (8/11/08) have been provided by the staff.

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 6, para. 4, line 3: for "27 percent" read "23 percent".
line 6: for "31 percent" read "30 percent".

Page 9, para. 7, line 5: for "imports but…government—have" read "imports—have"

Page 14, footnote 7, line 2: for "12 percentage" read "17 percentage"
line 3: for "28 percent" read "39 percent"
line 5: for "50 percent" read "53 percent"

Page 18, footnote 10, first line: for "7½ percent" read "10 percent"
for "15½ percent" read "23 percent"
last sentence: sentence removed

Page 22, footnote 13, first line: for "management have increased"
read "management is expected to increase"

Page 28, **Table 1, line 19 (Export volume), columns 2005, 2006, 2007:** data revised
line 20 (Import volume), column 2006: data revised
line 21 (Terms of trade), columns 2004, 2005, 2006, 2007: data revised
line 28 (Overnight call rate), columns 2005 and 2006: data revised
line 29 (Tree-year AA-corporate bond yield), column 2006: data revised

Page 30, **Table 3, line 16 (Domestic financing), column 2007:** for "-32.9" read "-33.0"
line 18 (External financing), column 2007: for "-0.9" read "-0.8"

Page 32, **Table 5, line 5 (One month call borrowing rate), column 2006:** for "4.5"
read "4.6
column 2007: for "4.6"
read "5.0"
line 6 (One month call borrowing rate(real)), column 2006: for "2.4"
read "2.5"
column 2007: for "2.9"
read "3.3"
line 10 (Terms of trade), columns 2004, 2005, 2006, 2007: data revised

Page 33, Table 6, line 24 (Volumes), columns 2006 and 2007: data revised.
line 26 (Volumes), column 2006: data revised.
line 27 (Terms of trade), columns 2006 and 2007: data revised.

Typographical Errors

Page 19, box 2, last para., last line: for "in the context an" read "in the context of an"

Page 20, para. 18, line 5: for "with the standing repo" read "with the repo"
line 9: for "banks or companies" read "banks or financial companies"

Questions may be referred to Mr. Schiff (ext. 38717) and Mr. Syed (ext. 39967) in APD.

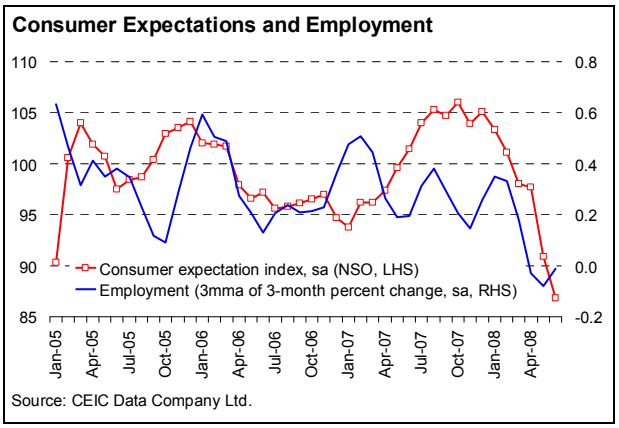
This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (11)

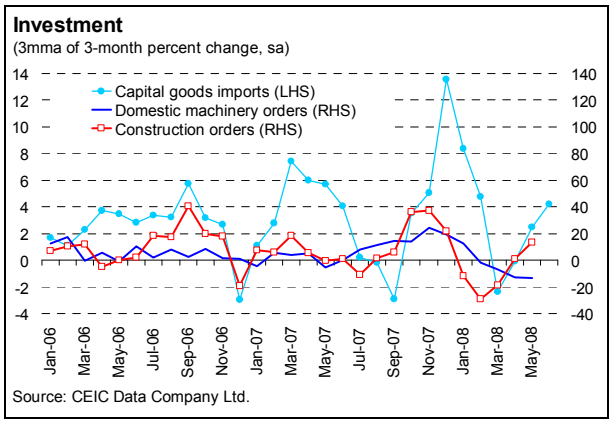
Other Distribution:
Department Heads

Figure 1. Recent Real Sector Developments

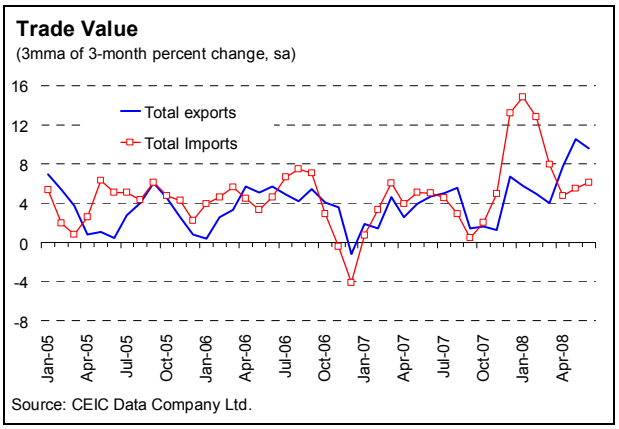
Most consumption indicators point downward...



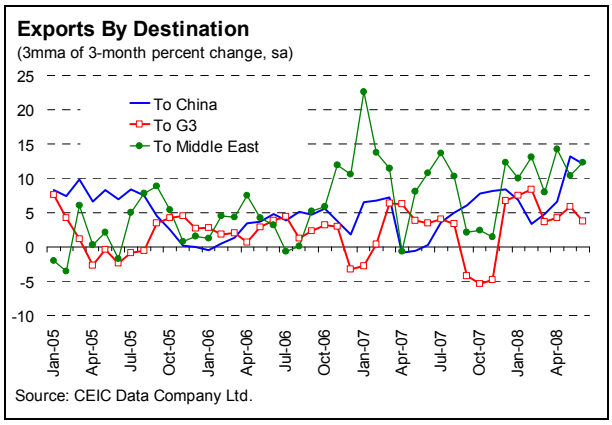
…while recent investment trends are more mixed.



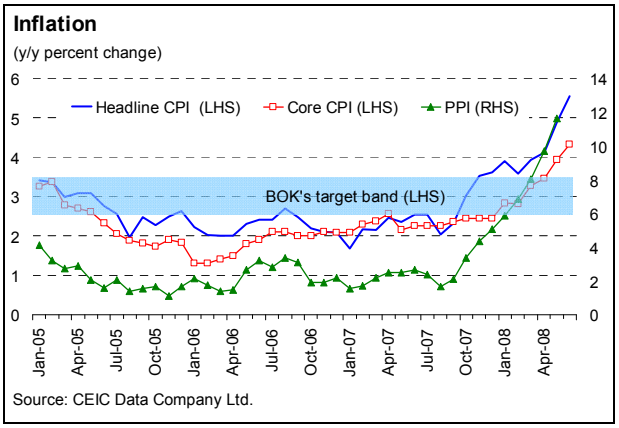
Exports have remained buoyant so far...



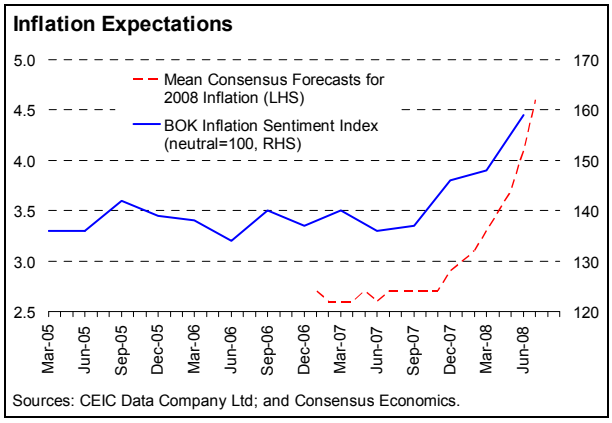
…with nontraditional markets playing an increasing role.



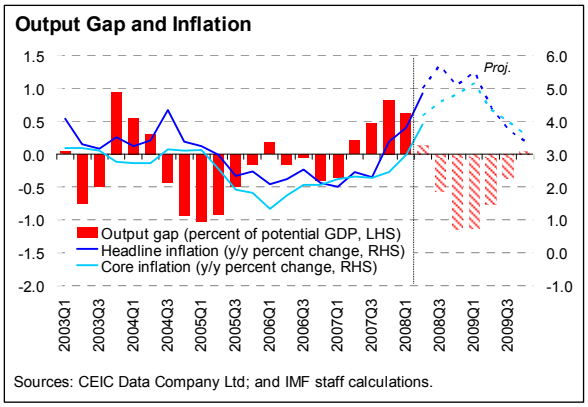
Inflationary pressures have picked up...



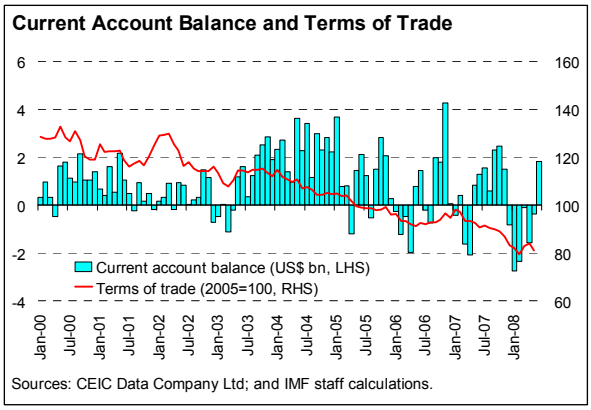
…as have inflationary expectations.

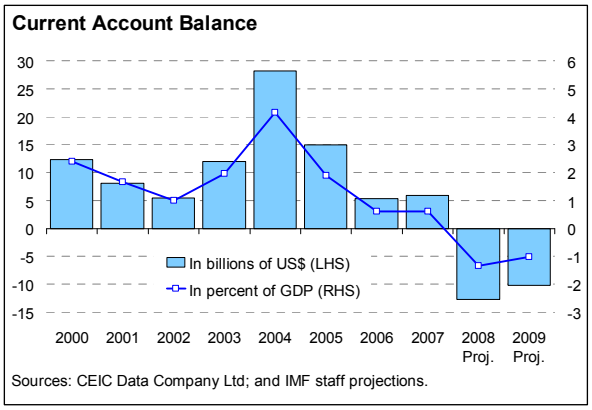


3. **At the same time, rising global commodity prices have led to a sharp increase in inflation pressures.** Headline inflation hit a near ten-year high of 5½ percent in June, and has exceeded the Bank of Korea (BOK) target range of 2½–3½ percent for eight consecutive months. Pressures from higher global commodity prices are being supported by still-strong money and credit growth and won depreciation. Core inflation is trending up, suggesting growing second-round effects, and inflation expectations are rising. While wage pressures are not yet evident, major labor negotiations are due this summer. However, under staff's central scenario, a negative output gap and moderating food and fuel price inflation should help bring headline inflation down starting the first quarter of next year, returning to the target band in the last quarter.



4. **The current account, hit hard by the deterioration in Korea's terms of trade, has been in deficit for most of 2008, but shows signs of improvement.** Export growth has remained robust through the second quarter (23 percent y/y), as weaker exports to the United States have been offset by growth in exports to China, the EU, Latin America and the Middle East (Figure 2). However, higher commodity prices have led imports to rise even more sharply (30 percent y/y). While the services deficit remains large, as Koreans continue to travel abroad, including for education, both trade and service balances have improved in recent months owing to a weaker won. A current account deficit of 1¼ percent of GDP is expected this year, declining to 1 percent in 2009 (Table 2). On the capital account, net equity and FDI outflows have more than offset bond and other inflows, mainly short-term bank borrowing (Figure 3).





5. **Korea's economy has demonstrated resilience in the face of the global financial turmoil, but has not escaped unscathed.** The direct impact of the global credit crisis has been small.[1] Nevertheless, indirect effects have been significant and broadly in line with regional developments: stock prices have declined; financial market volatility has increased; spreads on external debt have widened; and the won has depreciated by around 7¾ percent against the dollar and by around 13 percent in real effective terms so far this year (Figure 4). Some financial sector risks have also emerged in the context of the global credit market strains, as discussed below.

6. **Risks to the outlook are sizable for both growth and inflation.** While the baseline scenario is relatively benign, with only a modest slowdown and a gradual return of inflation to its target range, there are more than the usual uncertainties surrounding these projections. A sharper or more prolonged global slowdown or further volatility in global financial conditions would have a significant impact on Korea's growth. While Korea's trade exposure to the United States and Europe is modest by Asian standards, financial effects could be larger, related to lower asset prices; increased volatility of capital flows and exchange rates; dampened confidence; and tighter liquidity and credit conditions. Should commodity prices rise further or wage pressures and other second-round effects become stronger, inflation could remain high, worsening the growth-inflation tradeoff.[2] On the upside, domestic demand could prove more resilient than expected, in particular if the government's pro-growth policies are enacted.

7. **A fractious political environment exacerbates the uncertainty in the outlook.** Lee Myung-bak won the December 2007 presidential election, and his conservative Grand National Party won a slim majority in parliamentary elections in April. However, large public protests—sparked by health concerns surrounding the decision to restart U.S. beef imports—have dogged the administration since early May, resulting in a plummeting of the president's approval ratings and a cabinet reshuffle. The administration's ability to implement its economic agenda, which aims to raise potential growth, may be restricted in the immediate aftermath.

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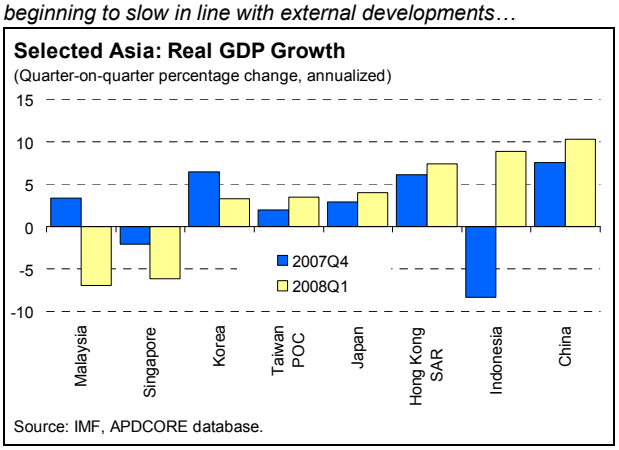
[1] Holdings by Korean banks of subprime-related RMBS and CDOs is reported to be around $660 million, and net exposure to structured investments around $2 billion (or 2 percent of banks' equity). Reported exposure of Korean banks and insurance companies to securities issued by Fannie Mae and Freddie Mac is also small, at around $550 million.

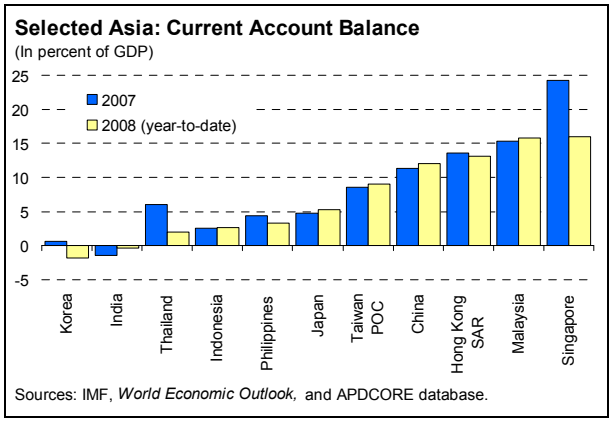
[2] A selected issues paper examines the macroeconomic impact of alternative shocks and outlines potential monetary policy responses. The results suggest that a 50 percent increase in oil prices relative to the baseline from the third quarter of this year would increase annual average inflation by around 0.2 percentage points in 2008 and 0.5 percentage points in 2009.

Figure 4. The Regional Context

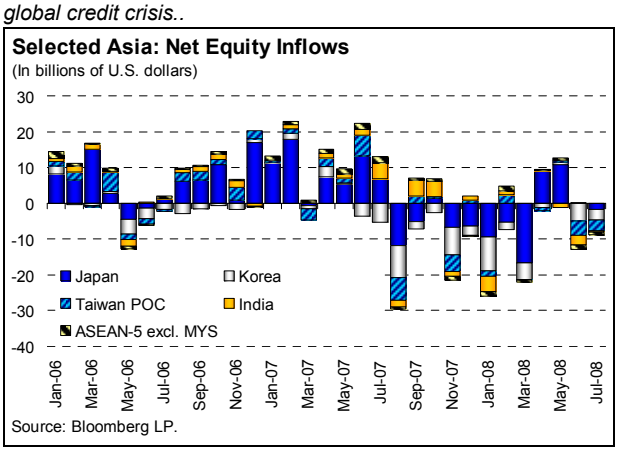
Unlike some parts of Asia, the Korean economy is already beginning to slow in line with external developments…



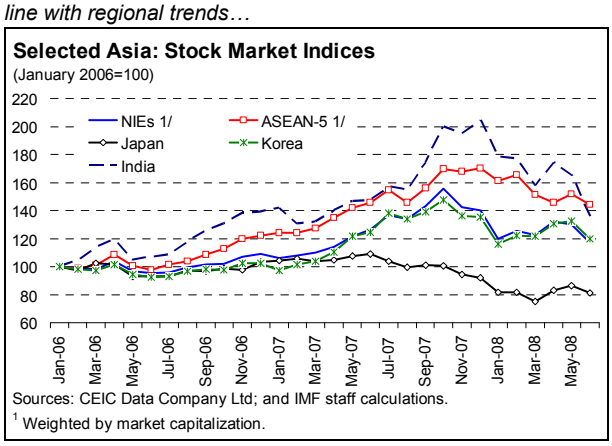
…and is one of the only major Asian economies to be running a current account deficit.



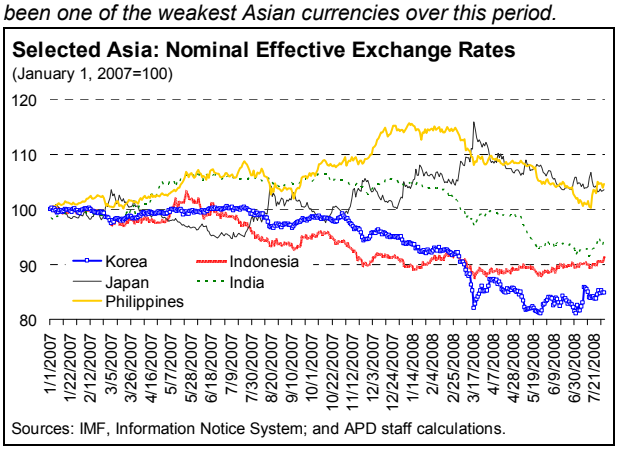
There have been sizable equity outflows since the start of the global credit crisis..



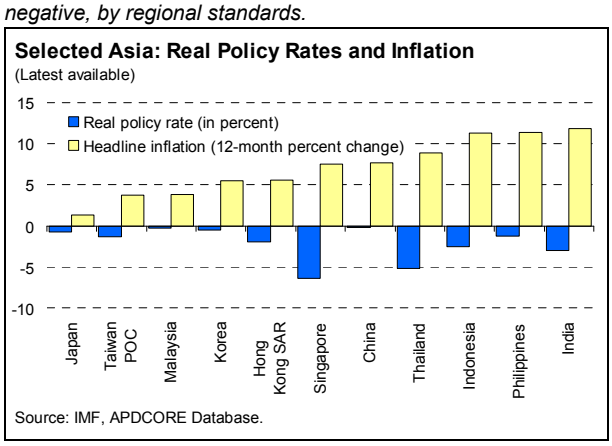
... depressing the Korean stock market, which has declined in line with regional trends…



…and contributing to a sharp depreciation in the won, which has been one of the weakest Asian currencies over this period.



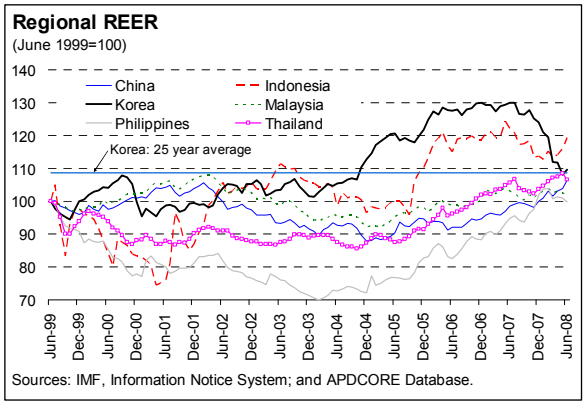
Inflation remains relatively low, and real interest rates less negative, by regional standards.



Box 1. Assessing the Exchange Rate and External Stability

While the won has depreciated sharply this year, staff finds that its recent movements are broadly in line with fundamentals—mainly the terms of trade—and the currency remains close to equilibrium. Relatedly, staff finds that the underlying current account is close to equilibrium and risks to external stability are modest.

Over the medium term, Korea's real effective exchange rate (REER) has been in line with the region. From this perspective, the recent fall in the won has reversed a three-year appreciation that was exceptional by regional standards.



In addition, Korea's REER is now in line with its 25-year average. This need not be viewed as an equilibrium level but is a reasonable proxy for a currency's purchasing power-parity (PPP) value, given estimates in the literature of the half-life of deviations from PPP.

A mid-cycle update of the February CGER exercise also suggests that the won and the current account are close to equilibrium.

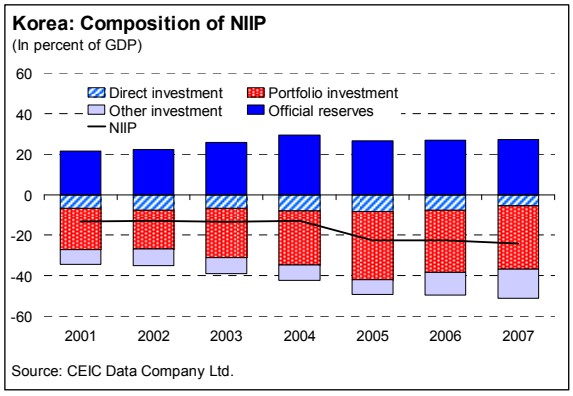
Exchange Rate Misalignment According to the CGER Exercise [1]
(Percent)

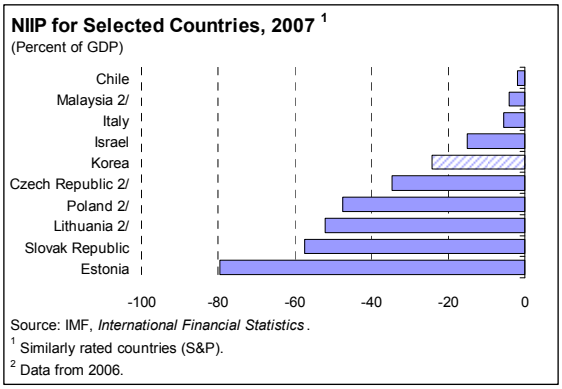
	February 2008 Assessment	July 2008 Staff Update
Equilibrium REER approach	-6	-15
Macro balance approach	4	2
External sustainability approach	0	0
Memorandum Item		
Expected percentage change in REER 5-years ahead		
Consensus forecast	1	
Forward rate	3	

[1] A positive number denotes an overvaluation.

- According to the equilibrium REER approach, Korea's equilibrium exchange rate depreciated by 2 percent on account of higher oil prices since February. With the actual REER falling by 11 percent since then, this implies that the won is now undervalued by 15 percent, compared to 6 percent in February.
- According to the macro balance approach, the current account norm moved to a deficit of ½ percent of GDP, from a balanced account in February, reflecting the deterioration in the oil balance. With an underlying current account deficit of 1.1 percent of GDP, this implies that the won is now overvalued by 2 percent, compared to 4 percent in February.
- According to the external sustainability approach, a current account deficit of 1.3 percent of GDP stabilizes Korea's NFA position. This implies zero misalignment.

The increasing size and the change in composition of Korea's net international investment position (NIIP) add modestly to external vulnerability, but the external position remains stable. The NIIP declined from a negative 13 percent of GDP in 2004 to a negative 24 percent in 2007 and the composition of liabilities shifted toward equity and short-term debt. However, the NIIP remains modest by international standards and the deterioration owes much to Korea's strong stock market performance in 2005 and bank borrowing that is backed by export proceeds from ship orders (Box 2).





Discussions

12. **Staff and the authorities agreed that with price pressures growing rapidly, efforts should be focused on ensuring that inflation expectations remain well anchored.** In particular, with liquidity and credit growth robust and a still-positive output gap, the mainly cost-push inflation could morph into a more pervasive inflation, raising sharply inflation expectations. In staff's view, an increase in policy rates would be appropriate at this time. While acknowledging the authorities' concerns about potential effects on household balance sheets, staff argued that an entrenchment of rising inflation expectations could require a more forceful—and more costly—tightening later and constrain economic growth.[7] With headline inflation likely to remain above the target range for some time, staff also stressed the importance of the BOK communicating clearly the consistency of price developments with the inflation targeting framework, whose credibility is facing its strongest test since its adoption. Looking ahead, staff saw potential scope for more accommodative monetary policies in the coming quarters, should inflation begin to moderate and growth remain soft. Should commodity prices rise further, policy options would become more difficult, but staff stressed that remaining ahead of the curve on inflation should continue to be a key objective. The authorities broadly agreed with this assessment, although not necessarily with the need for a rate hike at this time. On the other hand, the BOK also saw accommodation as less likely given their more optimistic growth outlook.

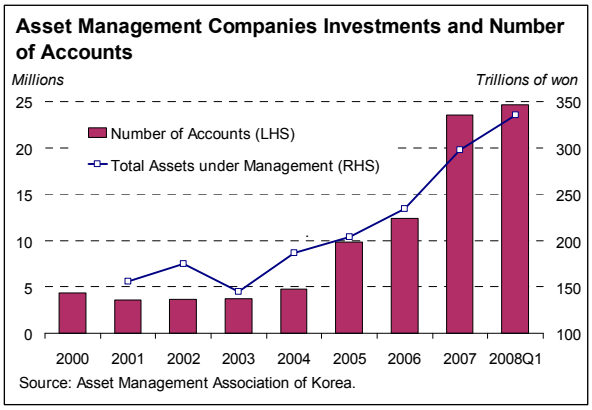
13. **While the authorities saw a role for the exchange rate in combating inflation, staff argued that exchange rate flexibility, with intervention limited to smoothing, remained appropriate.** The authorities reiterated that they viewed recent interventions as temporary and were not seeking to target a particular exchange rate level, but saw slowing the depreciation of the won as part of their arsenal in combating price pressures. Staff argued that intervention would be costly and unlikely to be effective in maintaining the exchange rate above its equilibrium for an extended period. Moreover, to maximize the effectiveness of the inflation targeting framework, efforts to combat inflation should be focused on the policy interest rate.

14. **This year's fiscal stance appears broadly appropriate, with only limited scope for further stimulus.** Staff argued that, in the context of a sharper or more prolonged slowdown, automatic stabilizers should first be allowed to operate. With growth remaining below potential, there could be room for further modest stimulus in the context of the 2009 budget, in particular to protect the most vulnerable, should commodity prices rise further. In this regard, staff stressed the need to ensure that any future transfers are

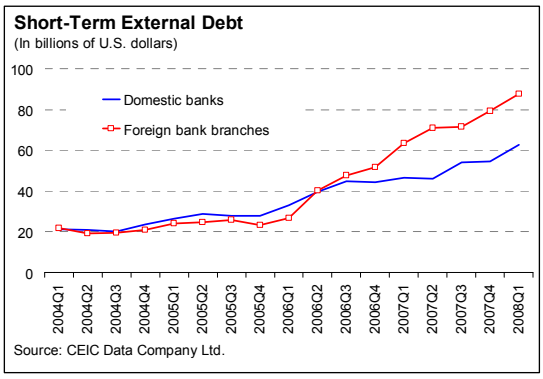
[7] A selected issues paper examines the sensitivity of household balance sheets to various shocks. The results suggest that a 300 bps increase in interest rates could increase households' debt-at-risk by about 17 percentage points (to 39 percent of total debt) and debt service-to-income ratios by 16 percentage points (to around 53 percent). These effects are 2–3 times larger than from a 100bps increase.

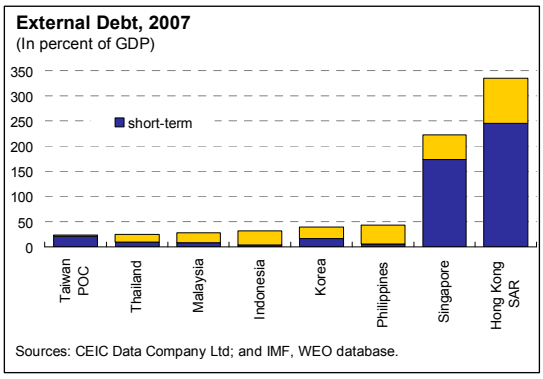
lending operations, which could expose Korean banks to liquidity risk should global credit conditions deteriorate further. However, foreign currency funding of Korean banks remains modest, at 7 percent of total funding, suggesting that risks are manageable.

- **A rapid withdrawal of funds from one or more asset management companies (AMCs) could also present liquidity risks.** Assets of AMCs have grown rapidly in recent years, and a deterioration in the global financial environment could leave them vulnerable to a sharp turnaround. Given the important role of AMCs in the money market (where they provide around 40 percent of funds), this could spill over to broader liquidity conditions and affect confidence in the financial system.[8]



- **Short-term external debt, largely borrowing by foreign bank branches, has risen sharply in the last two years.** Such borrowing has been largely the counterpart to hedging-related forward contracts and, more recently, to take advantage of arbitrage opportunities in the sovereign bond market. In response, in the second half of 2007, the authorities adopted several policies that effectively tightened foreign currency funding, adding to concerns about dollar liquidity risks and contributing to the persistent deviations from covered interest parity.[9] While sudden reversals of these flows could prove disruptive, their size and nature do not currently raise alarm bells, and such borrowing has shown recent signs of slowing (Box 2).

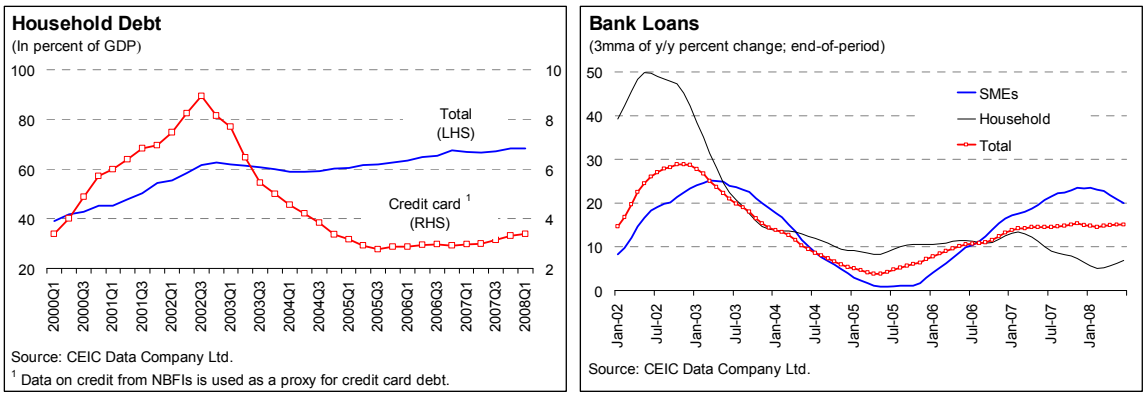




[8] Receipts from redemptions by AMC investors might be re-deposited with banks but there may be timing issues which would add to liquidity risk for banks.

[9] Beyond the extensive use of moral suasion, restrictions were imposed on foreign currency loans in August 2007; and the maximum tax deductible on interest paid on related-party loans for domestic branches of foreign banks was reduced from six to three times capital (the "thin-cap" rule) in January, but reversed in July.

- **While banks' overall asset quality is strong, an economic slowdown could reveal new vulnerabilities**. The sustained rapid growth of lending to SMEs, at nearly 20 percent (y/y), carries risks, in particular as their profits are low and there is little evidence that increased borrowing has been translated into higher investment. Another concern is a possible deterioration of asset quality related to exposures to the slumping construction and real estate development sectors, especially for mutual savings banks (MSBs) but, given the modest size of MSBs, these risks are not systemic. In addition, the high level of household debt at nearly 70 percent of GDP—most of which is variable rate—raises the sensitivity of balance sheets to credit and income shocks, while the expiration of grace periods on newer amortizing loans could pose a challenge over the next several years.[10]



Discussions

17. **The authorities agreed with staff on the nature of the liquidity risks faced by Korean banks, and have strengthened their oversight of these in the wake of the global financial turmoil.** Financial regulators have strengthened monitoring of short-term liquid asset ratios and have been tracking domestic banks' external debt on a daily basis since last August. Staff agreed that these measures are helpful, but stressed that recent international experience points to the need for strengthening stress-testing—in particular to allow for the possibility of large and multiple shocks and to account for the possible evaporation of liquidity in some asset classes during crises—as well as closer integration of such tests with banks' contingency plans. Staff also suggested that the BOK and financial regulator should ensure that their own stress tests adequately account for the possibility of multiple shocks, contagion between financial institutions, and macroeconomic effects, and are linked to their

[10] In 2008 and 2009, 10 percent and 23 percent, respectively, of total housing loans outstanding as of the second half of 2007 will be affected.

Box 2. External Debt Developments

Korea's total external liabilities increased by $152 billion since end-2006 to $412 billion, or nearly 40 percent of GDP, in the first quarter of 2008. More than 40 percent of the increase has been short-term borrowing, raising concerns about the possibility of increased volatility or rapid reversals of flows.

Korea's External Debt, 2006-2008Q1
(In billions of US$)

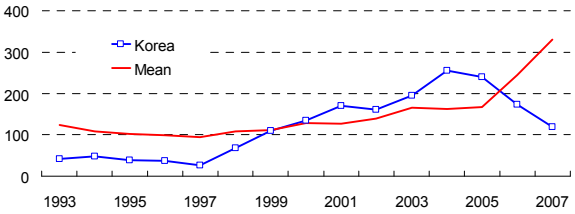
	2006 Q4	2007 Q4	2008 Q1	change (2008Q1-2006Q4)
Gross External Debt	260.1	382.2	412.5	152
Short-term	113.7	160.3	176.5	63
Long-term	146.3	221.9	236.0	90
Gen. Govt. and BOK	19.9	53.3	58.0	38
Banks	136.5	194.0	214.4	78
Domestic banks	82.1	110.2	122.1	40
Short-term	44.3	54.6	62.6	18
Foreign bank branches	54.4	83.8	92.3	38
Short-term Loans	50.3	75.7	83.5	33
Other Sectors	103.6	134.8	140.1	37
Long-term	89.9	116.5	121.5	32
Bonds and notes	30.7	41.4	42.1	11
Trade credits	35.0	47.2	51.0	16

Source: Bank of Korea.

However, concerns should not be exaggerated. External debt is not unusually high by standard vulnerability indicators (Table 5), or compared to countries with similar credit ratings. In addition:

- **Around half of the increase in short-term borrowing has been in the context of banks providing currency hedging.** Typically, exporters (particularly shipbuilders) and domestic investors abroad sell expected dollar receipts forward to domestic banks and foreign bank branches (FBB) in Korea, which borrow dollars abroad to match their currency exposure. The rapid increase in hedging related debt flows has reflected a sharp rise in ship orders and exporters' hedging ratios and increased outward investment (Figure 3).[1] Such borrowing has been particularly pronounced for FBBs: as a large portion of their borrowing comes from their headquarters, rollover risk would not be subject to the counterparty risk that has hampered interbank markets globally. Nevertheless, close monitoring and cooperation with parent supervisors would need to continue.

Gross International Reserves to Short-Term External Debt at Remaining Maturity plus Current Account Deficit[1,2]
(In percent)



Source: IMF, Vulnerability Exercise Database, March 2008.
[1] Reserves (end of current year) in percent of ST debt at original maturity (end current year) plus amortization of MLT debt and current account deficit (following year). The current account is set to zero if it is in surplus.
[2] Covers 49 countries.

- **Another 11 percent of the rise in external debt reflects advance receipts for ship exports, which show up as trade credits until delivery.** As this debt is backed by future exports, little risk would seem to be attached.
- **Around 25 percent of the overall increase in external debt relates to purchases of Korean sovereign bonds by nonresidents.** This is won denominated and driven by the possibility of arbitrage gains. While such flows could be reversed, foreign holdings of Korean sovereign bonds remain quite modest, at less than 10 percent of the total. Domestic banks have also increased their foreign currency external borrowing since 2006, although their reliance on external funding remains limited.

Recent BOP data suggest that external debt has begun to moderate and this trend is expected to continue. Reduced forward selling could be expected from a slowing in both the growth of ship orders and investment abroad by Korean residents in the context of the global slowdown. Recent exchange rate developments may also reduce desired hedging ratios, as much of the previous hedging was in the context of an appreciating trend for the won.

[1] For more details, see Box 1 of *Republic of Korea: 2007 Article IV Consultation—Staff Report* (IMF Country Report No. 07/344).

contingency planning. Finally, staff underlined the importance of reviewing communication and cooperation between supervisors, the central bank and the government to ensure the necessary procedures are in place to coordinate responses under stress scenarios. The authorities were receptive to these suggestions and are in the process of developing an official coordination forum to complement ongoing monthly inter-agency meetings.

18. **The authorities indicated that options for providing liquidity during extreme financing stress were adequate.** The authorities felt that there was sufficient scope for providing liquidity support to banks if needed, given the large stock of eligible collateral in the form of outstanding public bonds on bank balance sheets (around $73 billion or around 19 percent of total wholesale funding of commercial banks) and with the repo facility established in March providing overnight liquidity to banks, with access confidential to address potential stigma. In addition, the BOK has the ability to relax collateral requirements at short notice, and under exceptional circumstances, open market operations could also be used to provide liquidity to individual banks or financial companies. Providing liquidity to nonbanks is less straightforward—it would likely require the BOK to do so indirectly via banks—and more problematic as a policy.

19. **Staff argued that preparedness for increased volatility also calls for a push to reform the money market.** Korea's money market is overly dependent on unsecured call money, reflecting insufficient pricing of credit risk and the costs of administering repos. As recent events in advanced economies have shown, having an effective repo market is especially important under stress conditions. A strategy to deepen money markets in Korea has been developed, and several key steps—including the abolishment of the withholding tax on repos for domestic financial institutions—have been taken. Despite this progress, however, there has not been a meaningful increase in secured lending to date. Staff emphasized that a concerted effort was needed to complete the money market reform agenda.[11]

20. **While the run-up in short-term external debt merits close monitoring, staff stressed that policies aimed at restricting capital inflows should be avoided.** The authorities agreed, although they were understandably concerned about potential vulnerabilities, and market views of such. Staff cautioned that measures aimed at limiting external borrowing were unlikely to prove effective for long, and could be counterproductive: such limits would tend to increase arbitrage opportunities encouraging potentially more volatile or less transparent inflows, and could have an adverse impact on investor confidence. Attempts to fine-tune capital flows by changing regulations, such as the changes to the "thin cap" rule, are likely to have similar drawbacks. Staff felt that policies

[11] Main remaining elements include the introduction of a master repo agreement to reduce transaction costs and the adoption of a transaction-based fee structure to encourage repo agreements with longer-term maturities.

should instead continue to focus on strengthening the financial sector's resilience to volatility and shocks by deepening markets and enhancing financial oversight.

21. **Staff suggested that other still-modest risks to asset quality could be addressed by continuing to strengthen risk management in financial institutions.** Adoption by banks of appropriate risk-assessment methods will be necessitated by the move from rules-based to risk-based supervision under Basel II, to which Korea is in the process of transitioning. The authorities agreed, and also noted that they were monitoring SME lending and default rates daily, particularly in the construction and wholesale/retail sectors, and that some measures had already been taken, such as ceilings on project finance lending by MSBs imposed late last year. With household debt increasing faster than income in recent years, the authorities were also carefully assessing any signs of a potential deterioration in debt servicing capacity. The authorities also indicated that they were monitoring the ongoing transition to amortizing loans closely, but thought that risks were small given that the delinquency rate on mortgages is very low, at 0.37 percent, and had declined in the past year.

C. The Future of Korea's Financial Sector: Fostering Growth and Innovation

Financial sector development has lagged overall economic development and deficiencies have been recognized by the authorities, as demonstrated in the Capital Market Consolidation Act (CMCA) that comes into effect in February 2009. Looking ahead, structural changes to the financial sector will present both challenges and opportunities.

Background

22. **The Capital Markets Consolidation Act (CMCA) should bring important benefits, but will also present new challenges for Korean banks and regulators.** The CMCA will remove restrictions that separate securities, futures, asset management, trust services, and other financial services businesses, and introduce a negative list for new financial products. The Act is also expected to lead to consolidation of the securities industry and emergence of domestic investment banks. Increased competition should generate efficiency gains, improve the allocation of capital, and raise the role of the financial sector in generating long-term growth. However, it will also place a premium on enhancing financial oversight and may increase wholesale funding dependence of banks, raising vulnerabilities and necessitating a change in their business models. With financial sector reforms, the government also plans to reduce the role of public banks and proposes to gradually raise the equity limit on nonfinancial corporate ownership of financial institutions from the current 4 percent to 10 percent.[12]

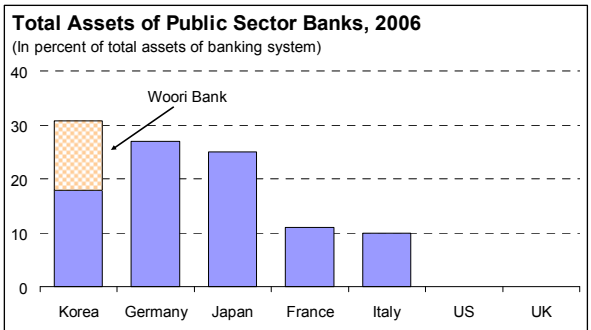
[12] A selected issues paper discusses financial sector challenges in the face of the CMCA.

23. **The establishment of the Korea Investment Corporation (KIC) was, in part, aimed at developing an asset management industry, but it has so far played a small role in this regard.** However, the KIC has recently expanded its assets under management.[13] KIC is a member of the International Working Group of Sovereign Wealth Funds, and is supportive of efforts to develop a voluntary code for such funds.

Discussions

24. **Staff stressed that financial oversight will need to evolve to address the changing nature of the sector.** Emphasis will need to be placed on adapting regulation to limit the scope for regulatory arbitrage; development by regulators and supervisors of skills to deal with more complex institutions and products; and ensuring that regulation does not stifle financial development. In this process, it will be critical to ensure that enhanced regulatory and supervision capacity precedes market growth and rapid innovation—indeed, a proper regulatory framework should be conducive to market development—and that supervision remains independent.[14] In the context of ongoing global financial stresses, staff suggested that the timing of the adoption of the CMCA also provides an important opportunity to reflect the lessons from the current crisis (Box 3). The authorities agreed with staff's assessment of the risks associated with the introduction of the CMCA, stressing in particular the challenges faced in building quickly supervisory skills to deal with the new environment.

25. **Staff welcomed the government's plans to reduce the role of public banks.** The planned privatization of Woori Bank, IBK and KDB could contribute importantly to the development of the financial sector. However, staff reiterated concerns regarding a potential loosening of restrictions on nonfinancial corporates owning banks, notably with regard to connected lending. The authorities explained that their objective was to move closer to advanced country standards and to broaden the investor base for financial institutions. While staff appreciated that the authorities are taking a measured approach, they underlined the need to ensure that any changes not threaten progress made on corporate governance. While the desire to bring new capital to the financial sector is



Sources: CEIC Data Company Ltd; Export-Import Bank of Korea, Annual Report, 2006; Banque de France; VOB, Annual Report 2005/06; and IMF FSAP, and Occasional Paper 2004, No. 233.

[13] KIC's assets under management is expected to increase from $20 billion to $30 billion this year, and it recently purchased a $2 billion stake in Merrill Lynch.

[14] In February, the Financial Supervisory Commission took over the financial policy making functions of the Ministry of Finance and was renamed the Financial Services Commission (FSC).

inflation begin to moderate and the economy remain soft in coming quarters, there may be scope for more accommodative policies. There could be room for modest fiscal stimulus in the 2009 budget, in particular to protect the most vulnerable should commodity prices rise further, but measures taken should be targeted, well-timed, and reversible. Korea's flexible exchange rate regime, with intervention limited to smoothing excessive volatility, has served the country well in the past and continues to be appropriate. In this context, utilizing intervention as a tool to combat inflation should be avoided; the inflation targeting framework remains the most appropriate policy tool to achieve this objective.

33. **While the Korean financial system remains sound, the ongoing global financial turmoil has raised some concerns.** International credit market stresses have underlined that banks reliant on wholesale funding may be exposed to greater liquidity risk. Supervisors are focused on limiting such risks, but international experience suggests that enhanced stress-testing and contingency planning would also help. Short-term external debt has risen sharply in recent years, as a counterpart to hedging activity, and more recently, with foreign purchases of sovereign bonds. This debt should be closely monitored, but its sources and uses are very different from those a decade ago, and risks remain moderate. Overall bank loan quality is strong but an economic slowdown could reveal some vulnerabilities, particularly in SME lending, which merits continued close attention. These risks point to the importance of banks continuing to strengthen risk management, including under their transition to Basel II.

34. **Looking ahead, structural changes to the financial sector will present both challenges and opportunities.** Increased financial sector competition, in light of the CMCA taking effect in 2009, should contribute to growth, but will require financial regulators to meet new challenges, including risks from more complex institutions and products. It will be critical to ensure that enhanced regulatory and supervision capacity precedes market growth and rapid innovation, and that financial supervision remains independent. The government's push to privatize remaining public sector banks is welcome but plans to ease restrictions on nonfinancial corporate ownership of banks should proceed in step with further improvements in corporate governance.

35. **The government aims to address structural challenges to Korea's impressive growth record, including through deregulation, privatization, and tax cuts.** While these plans are mostly welcome, proposals for reducing any tax rates should be in the context of a broader plan to concretely address long-run fiscal pressures, notably those associated with Korea's rapidly aging population.

36. It is recommended that the next Article IV consultation take place on the standard 12-month cycle.

Table 1. Korea: Selected Economic Indicators, 2004–09

Nominal GDP (2007): $969.7 billion
Main exports (percent of total, 2007): Electronics (36), road vehicles (13), and vessels (7).
GDP per capita (2007): $20,011
Unemployment rate (2007): 3.3 percent
FDI (2007): $1.6 billion
Public debt (2007): 32.1 percent of GDP
Foreign public debt (2007): 3.2 percent of total public debt

	2004	2005	2006	2007	2008	2009
					Proj.	
Real GDP (percent change)	4.7	4.2	5.1	5.0	4.1	4.3
Total domestic demand	1.8	3.3	4.5	4.0	3.0	4.1
Final domestic demand	1.0	3.4	4.4	4.5	2.5	4.1
Consumption	0.4	3.9	4.8	4.7	3.0	3.6
Gross fixed investment	2.1	2.4	3.6	4.0	1.6	5.3
Stock building 1/	0.8	-0.1	0.1	-0.4	0.4	0.0
Net foreign balance 1/	3.3	1.3	1.3	1.3	1.2	0.6
Nominal GDP (in trillions of won)	779.4	810.5	848.0	901.2	950.4	1,020.8
Saving and investment (in percent of GDP)						
Gross national saving	34.5	32.0	30.5	30.0	28.5	29.0
Gross domestic investment	30.4	30.1	29.8	29.4	29.9	30.0
Current account balance	4.1	1.9	0.6	0.6	-1.3	-1.0
Prices (percent change)						
CPI inflation (end of period)	3.0	2.6	2.1	3.6	5.6	3.3
Core inflation (average)	2.9	2.3	1.8	2.3	4.1	4.3
GDP deflator	2.7	-0.2	-0.5	1.2	1.3	2.9
Real effective exchange rate 2/	1.8	12.1	7.4	0.1	-9.8	…
Trade (percent change)						
Export volume	22.5	9.1	13.2	10.4	8.6	8.7
Import volume	11.8	6.4	10.5	9.0	9.4	9.7
Terms of trade	-4.2	-7.3	-6.6	-2.5	-6.0	1.5
Consolidated central government (in percent of GDP) 3/						
Revenue	22.9	23.6	24.7	27.0	26.1	25.8
Expenditure 4/	20.7	21.7	22.9	23.3	24.5	24.0
Overall balance 4/	2.2	1.9	1.8	3.8	1.6	1.8
Excluding Social Security Funds	-0.5	-1.0	-1.3	0.4	-1.3	-1.5
Money and credit (end of period)						
Overnight call rate 5/	3.3	3.8	4.6	5.0	5.0	…
Three-year AA- corporate bond yield 5/	3.7	5.5	5.3	6.8	6.9	…
M3 growth 6/	7.1	7.4	10.5	10.0	13.2	…
Balance of payments (in billion U.S. dollars)						
Exports, f.o.b.	257.7	289.0	331.8	379.0	437.2	489.7
Imports, c.i.f.	220.1	256.3	303.9	349.6	432.1	481.6
Oil imports	29.9	42.6	55.9	60.3	101.7	113.6
Current account balance	28.2	15.0	5.4	6.0	-12.7	-10.3
Gross international reserves (end of period)	199.0	210.3	238.9	262.1	253.1	250.8
In percent of short-term debt	254.3	239.6	172.5	130.9	105.8	95.4
External debt (in billion U.S. dollars)						
Total external debt (end of period)	172.3	187.9	260.1	382.2	456.8	503.3
Of which : Short-term (end of period)	56.3	65.9	113.7	160.3	191.4	210.2
Total external debt (in percent of GDP)	25.3	23.7	29.3	39.4	48.1	49.3
Debt service ratio 7/	10.7	7.9	7.4	7.5	8.4	9.6

Sources: Korean authorities; and Fund staff estimates and projections.

1/ Contribution to GDP growth.
2/ Data for 2008 are for April.
3/ Refers to budget plans for 2008 and 2009, with staff adjustments.
4/ Excluding privatization receipts and rollover of KDIC/KAMCO bonds.
5/ Data for 2008 are as of July 28.
6/ Data for 2008 are as of May.
7/ Debt service on medium- and long-term debt in percent of exports of goods and services.

Table 2. Korea: Balance of Payments, 2004–08

(In billions of U.S. dollars, unless otherwise indicated)

	2004	2005	2006	2007	2008 Proj.
Current account balance	28.2	15.0	5.4	6.0	-12.7
Trade balance	37.6	32.7	27.9	29.4	5.1
Exports	257.7	289.0	331.8	379.0	437.2
(growth rate, in percent)	30.6	12.1	14.8	14.2	15.4
Imports	220.1	256.3	303.9	349.6	432.1
(growth rate, in percent)	25.6	16.4	18.6	15.0	23.6
Services	-8.0	-13.7	-19.0	-20.6	-14.0
Income	1.1	-1.6	0.5	0.8	-0.1
Current transfers	-2.4	-2.5	-4.1	-3.6	-3.7
Financial and capital account balance	9.4	7.0	18.5	6.7	4.1
Financial account	11.2	9.3	21.6	9.1	6.6
Portfolio investment, net	8.6	-1.7	-22.7	-19.1	-18.0
Direct investment, net	4.6	2.0	-4.5	-13.7	-8.5
Inflows	9.2	6.3	3.6	1.6	1.5
Outflows	-4.7	-4.3	-8.1	-15.3	-10.0
Other investment, assets	-8.1	-2.7	-7.9	-18.4	-10.0
Other investment, liabilities	6.1	11.7	56.8	60.3	43.1
of which trade credits	8.1	7.8	13.1	13.5	15.6
of which short-term loans	3.3	5.7	42.4	34.0	25.0
of which medium and long-term loans	-2.4	-2.5	2.2	8.1	1.5
Capital account	-1.8	-2.3	-3.1	-2.4	-2.5
Net errors and omissions	2.9	0.1	-1.2	2.9	0.0
Overall balance (1+2+3)	40.5	22.1	22.6	15.6	-8.6
Financing	-40.5	-22.1	-22.6	-15.6	8.6
Change in usable reserves (increase -)	-38.7	-19.8	-22.1	-15.1	9.1
Net IMF purchases	0.0	0.0	0.0	0.0	0.0
World Bank/AsDB 1/	-1.8	-2.2	-0.5	-0.5	-0.5
Memorandum items:					
Current account balance (in percent of GDP)	4.1	1.9	0.6	0.6	-1.3
Trade balance (in percent of GDP)	5.5	4.1	3.1	3.0	0.5
Gross reserves	199.0	210.3	238.9	262.1	253.1
(in months of imports of goods and services)	8.8	8.0	7.7	7.3	5.8
External debt	172.3	187.9	260.1	382.2	456.8
(in percent of GDP)	25.3	23.7	29.3	39.4	48.1
Short-term external debt (inc. trade credits)	56.3	65.9	113.7	160.3	191.4
Nominal GDP	680.0	791.4	887.7	969.7	950.4

Sources: Korean authorities; and Fund staff estimates and projections.

1/ These World Bank and Asian Development Bank loans were extended as exceptional financing in the 1997-98 crisis.

Table 3. Korea: Consolidated Central Government Operations, 2004–08

	2004	2005	2006	2007	2008 Proj.
			(In trillions of won)		
Revenue	178.8	191.4	209.6	243.6	248.2
Tax revenue	117.8	127.5	138.0	161.5	166.6
Social security contributions	22.8	24.9	27.3	29.7	31.8
Nontax and capital revenue	38.1	39.1	44.2	52.4	49.8
Expenditure and net lending	161.5	175.9	193.9	209.8	233.0
Current expenditure 1/	133.1	148.3	161.7	169.7	191.9
Interest	8.7	10.1	12.2	13.4	14.3
Of which: bank restructuring	3.1	1.6	0.8	0.0	0.0
Non-interest	124.4	138.2	149.5	156.2	177.7
Capital expenditure	27.0	24.6	26.5	33.0	35.9
Net lending 2/	1.4	3.0	5.7	7.1	5.1
Overall balance	17.2	15.5	15.6	33.8	15.2
Of which: Social Security Fund balance	21.2	23.6	26.4	30.2	28.0
Excluding Social Security Funds	-4.0	-8.1	-10.8	3.6	-12.8
Financing	-17.2	-15.5	-15.6	-33.8	-15.2
Domestic financing	-14.6	-12.7	-14.8	-33.0	-15.2
Of which : Privatization	0.0	0.0	0.0	0.0	0.0
External financing	-2.6	-2.8	-0.8	-0.8	0.0
			(In percent of GDP)		
Revenue	22.9	23.6	24.7	27.0	26.1
Tax revenue	15.1	15.7	16.3	17.9	17.5
Social security contributions	2.9	3.1	3.2	3.3	3.3
Nontax and capital revenue	4.9	4.8	5.2	5.8	5.2
Expenditure and net lending	20.7	21.7	22.9	23.3	24.5
Current expenditure	17.1	18.3	19.1	18.8	20.2
Interest	1.1	1.2	1.4	1.5	1.5
Non-interest	16.0	17.0	17.6	17.3	18.7
Capital expenditure	3.5	3.0	3.1	3.7	3.8
Net lending	0.2	0.4	0.7	0.8	0.5
Overall balance	2.2	1.9	1.8	3.8	1.6
Of which: Social Security Fund balance	2.7	2.9	3.1	3.4	2.9
Excluding Social Security Funds	-0.5	-1.0	-1.3	0.4	-1.3
Primary balance	3.3	3.2	3.3	5.2	3.1
Memorandum items :					
Privatization receipts	0.0	0.0	0.0	0.0	0.0
Conversion of KDIC/KAMCO bonds	-1.5	-1.5	-1.4	…	…
Nominal GDP (trillion won)	779.4	810.5	848.0	901.2	950.4

Sources: Ministry of Planning and Budget; and Fund staff estimates and projections.

1/ The conversion of KDIC and KAMCO bonds is excluded, amounting to W 13 trillion in 2003, and W 12 trillion annually until 2006.
2/ Excludes privatization receipts.

Table 4. Korea: Financial Soundness Indicators, 2001–07

	2001	2002	2003	2004	2005	2006	2007
Financial Sector				(In percent)			
Total loans/GDP	103.6	119.5	97.8	94.2	98.1	109.7	119.2
Commercial banks	60.9	67.9	68.9	65.7	67.6	76.1	81.4
Other financial institutions	42.6	51.6	28.9	28.5	30.5	33.6	37.8
Bank loans				(Year-on-year percent change)			
SMEs	7.9	23.5	17.9	3.0	4.7	17.7	22.4
Households	38.9	38.3	13.8	8.9	10.7	13.4	5.1
Large companies	-27.3	0.4	-13.3	-11.1	15.9	-4.6	31.2
				(In percent)			
FX loans/total loans to SMEs	...	5.5	5.5	5.0	5.5	6.9	5.2
Banks 1/				(In percent)			
Capital adequacy ratio	11.7	11.3	11.2	12.1	13.0	12.8	12.3
Tier 1 capital ratio	7.7	7.2	7.0	8.0	9.3	9.2	8.9
Return on assets	0.7	0.6	0.2	0.9	1.3	1.1	1.1
Net interest margin	2.6	2.7	2.6	2.6	2.8	2.6	2.4
Substandard or below loans, share				(In percent of total loans)			
Commercial banks	3.3	2.4	2.8	2.0	1.3	0.9	0.7
Specialized banks	3.6	2.1	2.4	1.7	1.1	0.7	0.7
Mutual savings banks	15.7	11.3	11.8	13.0	13.8	10.5	8.8
Credit unions	9.9	6.1	6.3	6.0	5.4	4.5	3.8
Corporate Sector				(In percent)			
Corporate debt/GDP 2/	…	116.7	115.8	111.5	111.2	120.5	127.3
Delinquency ratio (domestic commercial bank loans)	2.1	2.0	2.1	2.1	1.5	1.2	1.0
Debt ratio to:							
Equity	182.2	135.4	123.4	104.2	100.9	98.9	…
Total assets	39.8	31.7	28.3	24.0	22.9	22.4	…
Sales	40.1	29.8	26.6	20.7	19.9	19.9	…
Interest coverage ratio 3/	132.6	260.3	367.1	575.8	525.4	439.3	469.8
Current assets/current liabilities	97.9	106.1	109.8	117.0	121.4	120.5	…
Operating income/sales	5.5	6.7	6.9	7.6	6.1	5.3	…
Financial expenses/sales	-4.2	-2.6	-1.9	-1.3	-1.2	-1.2	…
Ordinary income/sales	0.4	4.7	4.7	7.8	6.5	5.7	…
Household Sector				(In percent of GDP)			
Household credit	54.4	62.5	59.8	60.1	62.6	67.5	68.3
Of which: Commercial banks	25.0	31.6	33.9	35.0	36.7	40.2	39.4
Delinquency ratio (all bank loans)				(In percent)			
Households	1.3	1.5	1.8	1.7	1.1	0.7	0.6
Credit card 4/	7.3	8.5	7.8	4.1	2.2	0.1	1.3
Housing prices, percent change	9.9	16.4	5.7	-2.1	4.0	11.6	3.1
Of which: Seoul	13.0	22.5	6.8	-1.4	6.3	18.9	5.4

Sources: Bank of Korea; Financial Supervisory Service; and CEIC Data Company Ltd.

1/ Includes nationwide commercial banks, regional banks and specialized banks.

2/ Includes nonfinancial corporations.

3/ Operating income to gross interest payments. Operating income treats depreciation as an expense, so this ratio is lower than calculations using earnings before interest, taxes, and depreciation allowance (EBITDA).

4/ Over 1 month.

Table 5. Korea: Indicators of Financial and External Vulnerability, 2003–08
(In percent of GDP, unless otherwise indicated)

	2003	2004	2005	2006	2007	2008	
							Date
Financial indicators							
Consolidated central government debt 1/	32.6	33.5	36.2	36.5	35.7	35.9	Proj.
Broad money (M3, percent change, 12-month basis)	4.7	7.1	7.4	10.5	10.4	13.2	May-08
Private sector credit (Dep. Corp. survey, percent change, 12-month basis)	2.3	0.8	8.5	16.2	16.8	19.8	May-08
One month call borrowing rate	3.9	3.3	3.8	4.6	5.0	5.0	Jun-08
One month call borrowing rate (real)	0.5	0.2	1.1	2.5	3.3	-0.5	Jun-08
External indicators							
Exports (percent change, 12-month basis in US$)	20.7	30.6	12.1	14.8	14.2	30.5	Jun-08
Imports (percent change, 12-month basis in US$)	18.0	25.6	16.4	18.6	15.0	33.0	Jun-08
Terms of trade (percent change, 12-month basis)	-6.1	-4.2	-7.3	-6.6	-2.5	-12.4	May-08
Current account balance (projection for full year)	2.0	4.1	1.9	0.6	0.6	-1.3	Proj.
Capital and financial account balance (projection for full year)	3.0	1.4	0.9	2.1	0.7	0.4	Proj.
Of which: Inward portfolio investment (debt securities etc.)	3.5	2.4	1.1	0.0	2.4	0.5	Proj.
Other investment (loans, trade credits etc.)	0.4	0.6	1.2	6.3	6.2	4.5	Proj.
Inward foreign direct investment in the form of debt or loans	0.1	0.2	0.1	0.1	0.1	...	
Gross official reserves (in US$ billion)	155.3	199.0	210.3	238.9	262.1	258.1	Jun-08
Central bank short-term foreign liabilities (in US$ billion)	2.1	2.0	2.2	3.9	8.2	...	...
Short-term foreign liabilities of the financial sector (in US$ billion)	27.0	30.0	32.2	40.4	60.2	...	...
Official reserves in months of imports GS (projection for full year)	8.6	8.8	8.0	7.7	7.3	5.8	Proj.
Broad money (M3) to reserves	6.5	6.3	6.5	6.9	6.9	6.9	May-08
Reserves to total short term external debt (in percent) 2/	194.9	254.3	239.6	172.5	130.9	105.8	Proj.
Total external debt	25.9	25.3	23.7	29.3	39.4	48.1	Proj.
Of which: Public sector debt	1.9	1.5	1.1	1.2	3.3	...	...
Of which: Short-term debt	8.4	8.3	8.3	12.8	16.5	20.1	Proj.
Total external debt to exports GS (in percent)	68.4	57.5	56.2	68.1	86.5	89.0	Proj.
External interest payments to exports GS (in percent)	1.4	1.1	1.4	1.7	1.9	0.6	Proj.
External amortization payments to exports GS (in percent)	11.7	9.6	6.6	5.7	5.6	7.8	Proj.
Exchange rate (per US$, period average)	1,192	1,146	1,024	955	929	1,006	Jul 28, 08
REER appreciation (+) (12-month basis)	1.7	1.8	12.1	7.4	0.1	-13.2	Apr-08
Financial market indicators							
Stock market index (KOSPI)	811	894	1379	1434	1360	1598	Jul 28, 08
Stock market index (KOSPI, percent change, 12-month basis)	29.2	10.2	54.3	4.0	-5.2	-15.1	Jul 28, 08
Foreign currency debt rating (Moody's/S&P)	A3/A-	A3/A-	A3/A	A3/A		A2/A	Jul 28, 08

Sources: Korean authorities; private market sources; and Fund staff estimates and projections.

1/ Including government guaranteed restructuring bonds issued by KDIC and KAMCO.
2/ Short-term debt measured on a residual maturity basis.

Table 6. Korea: Medium-Term Projections, 2006–13
(In units indicated)

	2006	2007	2008	2009	2010	2011	2012	2013
			Staff Projections					
Real GDP (percent change)	5.1	5.0	4.1	4.3	4.9	4.8	4.7	4.6
Total domestic demand	4.5	4.0	3.0	4.1	4.6	4.6	4.5	4.5
Final domestic demand	4.4	4.5	2.5	4.1	4.6	4.6	4.5	4.5
Consumption	4.8	4.7	3.0	3.6	4.2	4.2	4.0	4.0
Gross fixed investment	3.6	4.0	1.6	5.3	5.6	5.6	5.6	5.7
Stock building 1/	0.1	-0.4	0.4	0.0	0.0	0.0	0.0	0.0
Net foreign balance 1/	1.3	1.3	1.2	0.6	0.8	0.8	0.7	0.7
Prices, period average (percent change)								
Consumer price	2.2	2.5	4.9	4.2	3.0	3.0	3.0	3.0
GDP deflator	-0.5	1.2	1.3	2.9	2.1	2.3	2.3	2.6
Savings and investment (percent of GDP)								
Gross national savings	30.5	30.0	28.5	29.0	29.1	29.1	29.2	29.3
Gross domestic investment	29.8	29.4	29.9	30.0	30.0	30.1	30.2	30.2
Current account balance	0.6	0.6	-1.3	-1.0	-0.9	-0.9	-1.0	-0.9
Consolidated central government (in percent of GDP)								
Revenue	24.7	27.0	26.1	25.8	25.7	25.7	25.7	25.6
Expenditure	22.9	23.3	24.5	24.0	23.5	23.2	23.0	22.7
Balance 2/	1.8	3.8	1.6	1.8	2.3	2.5	2.7	2.9
Excluding Social Security Funds	-1.3	0.4	-1.3	-1.5	-1.3	-1.2	-1.0	-0.8
Debt, domestic plus external 3/	32.2	32.1	32.8	32.9	33.0	32.8	32.4	31.7
Government guaranteed restructuring bonds 3/	4.3	3.6	3.1	2.6	2.1	1.6	1.2	0.8
Trade (percent change)								
Merchandise exports	14.8	14.2	15.4	12.0	11.6	12.0	12.2	12.2
Volumes 4/	13.2	10.4	8.6	8.7	10.8	10.8	10.5	10.4
Merchandise imports	18.6	15.0	23.6	11.5	11.8	12.1	12.2	12.0
Volumes 4/	10.5	9.0	9.4	9.7	11.6	11.7	11.5	11.4
Terms of trade	-6.6	-2.5	-6.0	1.5	0.5	0.7	0.9	1.0
Balance of payments (billions of U.S. dollars)								
Current account	5.4	6.0	-12.7	-10.3	-10.1	-11.1	-12.5	-11.7
Trade balance	27.9	29.4	5.1	8.1	7.8	7.9	9.1	11.0
Merchandise exports	331.8	379.0	437.2	489.7	546.3	611.8	686.4	769.9
Merchandise imports	303.9	349.6	432.1	481.6	538.5	603.9	677.4	759.0
External debt								
In billion of U.S. dollars 5/	260.1	382.2	456.8	503.3	540.8	578.7	618.2	660.8
(as percent of GDP)	29.3	39.4	48.1	49.3	49.5	49.4	49.2	49.0
Debt service ratio 6/	7.4	7.5	8.4	9.6	10.7	10.3	9.9	9.5
Memorandum items:								
Nominal GDP (trillion won)	848	901	950	1,021	1,093	1,172	1,256	1,348
Per capita GDP (U.S. dollars)	18,380	20,011	19,575	20,982	22,429	23,999	25,656	27,481
Output gap (percent of potential GDP)	-0.1	0.3	-0.3	-0.6	-0.3	-0.1	-0.1	0.0

Sources: Korean authorities; and Fund staff estimates and projections.

1/ Contribution to GDP.

2/ Excluding privatization receipts and conversion of KDIC/KAMCO bonds into treasury bonds.

3/ During 2003-06, W 49 trillion in government guaranteed KDIC/KAMCO bonds have been converted into treasury bonds.

4/ Customs clearance basis.

5/ Includes IMF and offshore borrowing of domestic financial institutions and debt contracted by their overseas branches.

6/ Debt service on medium- and long-term debt in percent of exports of goods and services.

INTERNATIONAL MONETARY FUND
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EXTERNAL RELATIONS DEPARTMENT

APPENDIX I

Public Information Notice (PIN) No.
FOR IMMEDIATE RELEASE

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IMF Executive Board Concludes 2008 Article IV Consultation with the Republic of Korea

On [September 8, 2008], the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Korea.[1]

Background

Difficult global conditions have made this a challenging year for Korea. First, against the backdrop of a global slowdown, economic activity in Korea is moderating. Second, surging global commodity prices and a weakening of the won are contributing to rising domestic inflation. Finally, while the Korean financial system remains in good health, increased global volatility has raised near-term risks, and ongoing structural changes to the financial sector present opportunities but also challenges to financial oversight.

After reaching 5 percent in 2007, growth is expected to moderate to 4.1 percent this year, before recovering to 4.3 percent in 2009. Headline inflation increased to 5.5 percent in June, exceeding the Bank of Korea's target of 2½−3½ percent for an eighth consecutive month. However, slowing domestic demand and moderating food and fuel price inflation should help bring headline inflation down early next year. Reflecting a sharp deterioration in Korea's terms of trade, a current account deficit of 1¼ percent of GDP is expected this year, declining to

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.