

**FOR
AGENDA**

SM/08/264
Supplement 2

September 5, 2008

To: Members of the Executive Board

From: The Secretary

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

The attached supplement to the staff report for the 2008 Article IV consultation with the Republic of Korea (SM/08/264, 8/11/08) has been prepared on the basis of additional information and is tentatively scheduled for discussion on **Monday, September 8, 2008**. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of the Republic of Korea indicating whether or not they consent to the Fund's publication of this paper; such communication may be received after the authorities have had an opportunity to read the paper.

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

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat forthwith; and to the Organisation for Economic Cooperation and Development, following its consideration by the Executive Board.

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

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INTERNATIONAL MONETARY FUND

REPUBLIC OF KOREA

Staff Report for the 2008 Article IV Consultation

Supplementary Information

Prepared by the Asia and Pacific Department

September 5, 2008

1. This supplement to the staff report summarizes the main developments since the staff report was issued on August 11, 2008. Staff projections and the thrust of the staff appraisal remain unchanged.
2. Recent data releases indicate that, as expected, growth is slowing while inflationary pressures remain elevated.
 - In line with staff projections and preliminary estimates, second quarter GDP data suggest that the economy expanded by 0.8 percent (q/q seasonally adjusted), the same rate as the previous quarter. Domestic demand weakness continued but net exports remained robust.
 - Exports have continued to perform well, rising by 33 percent (y/y) in July, on resilient demand from emerging markets. However, the current account swung back into a sizeable deficit of about \$2½ billion in July, with an oil-price-related surge in imports (46 percent, y/y) and increased spending on overseas travel. The financial account deficit rose to \$5½ billion from \$4 billion in June, reflecting continued large net equity outflows. Preliminary August trade data indicate that, despite some slowing, both import and export growth remained robust. Reserves fell by around \$4 billion in August, pointing to a slowdown in intervention.
 - Indicators of domestic demand point to a continued moderation of growth, consistent with staff projections. Business confidence stabilized in August, albeit at low levels, while consumer confidence fell further in July, to a near eight-year low. On a sequential basis (m/m seasonally adjusted), industrial output declined by 0.2 percent in July, but real retail sales growth rebounded to 5.1 percent after two months of contraction and service sector output picked up by 1.8 percent after remaining flat during May-June. Employment growth also picked up in July to 0.16 percent, the fastest pace since January, but remains relatively sluggish.

- Headline inflation fell slightly to 5.6 percent (y/y) in August from a decade-high of 5.9 percent in July, helped by the decline in global oil prices, but remained above the Bank of Korea's (BOK) target range for the tenth consecutive month. However, there is increasing evidence of second-round effects, with core inflation edging up from 4.6 percent to 4.7 percent.
3. The won has weakened further since August 11, falling by around 8¼ percent against the dollar to a near-five year low and around 6¾ percent in nominal effective terms. In the last two sessions, the won has recovered by 2⅔ percent against the dollar. Two of the three CGER approaches—the macro balance and external sustainability approach—continue to show the won as appropriately valued. However, the average of the three approaches yields an undervaluation of around 7 percent. The Korean stock market has declined to a 17-month low, down nearly 26 percent for the year, broadly in line with other Asian emerging markets. Foreign investors have continued their sell-off, albeit at a slower pace, with their net selling falling to \$3 billion in August from \$5 billion in July. In staff's view, underlying macroeconomic and financial vulnerabilities remain as assessed in the Staff Report.
4. The BOK tightened monetary policy in August. After a one-year pause, the BOK raised its policy rate by 25 bps, to 5¼ percent, citing continued concern about liquidity growth and the need to anchor inflation expectations. This year's fiscal stimulus package and corporate tax reform legislation are still pending approval in parliament.