

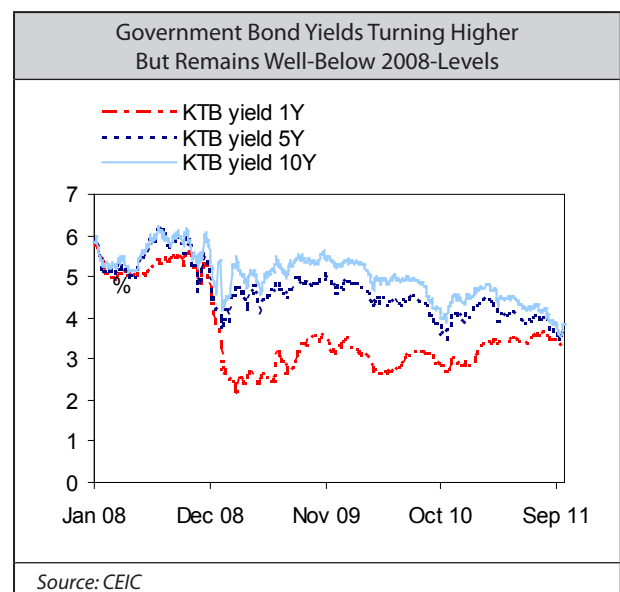
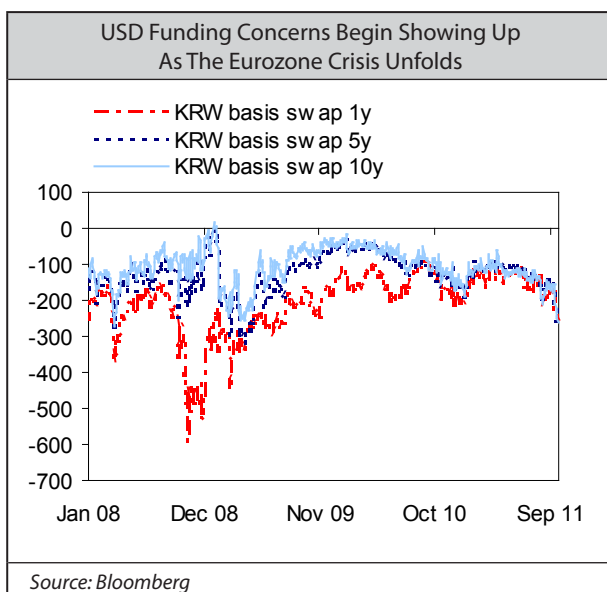
South Korea

UOB Economic Projections	2009	2010	2011F	2012F
GDP	0.3	6.2	4.2	4.2
CPI (average, y/y %)	2.8	3.0	4.5	3.4
Unemployment rate (s/adj, 4Q avg %)	3.5	3.4	3.3	3.3
Current account (% of GDP)	3.9	2.8	1.6	1.3
Fiscal balance (FY, % of GDP)	-4.1	-1.1	-2.0	-1.5

- Financial market gyrations brought concerns on USD-funding and outflows of foreign money from the domestic bond and equity markets. We have raised our year-end target for USD/KRW to 1,170 but meanwhile, the pair could test higher if the 500 pips surge during the global financial crisis in 2008 is any gauge.
- Given the significant increase in external risks, we are now expecting the BoK to keep its benchmark policy rate steady at 3.25% through 2012.
- Although growth risks have become more apparent, inflation is also showing upside risk. We have recently lowered our GDP growth forecast to 4.2% from 4.6% (with downside risk) and raised our inflation forecast to 4.5% from 4.1%. This puts the BoK in a tight spot.
- Going forward, consumption demand will likely continue to be the key growth driver, supported by a low interest rate environment. However, investment and exports expansion will face strong headwinds from the economic and fiscal woes in US and the EU.

The KRW was one of the worst-hit currencies in Asia in the current market pullback, correcting more than 10% against USD from its closing low of 1,050 at the end of July. The market rout has resulted in more than KRW\$5.8 tn (US\$5.4 bn) foreign money leaving the Korean equities since the start of August. While the BoK will likely continue to smooth out the volatile moves in the currency (government has lifted the ceiling of its treasury bond sales in 2012), the near-term

outlook for KRW has turned sharply negative due to the downbeat global outlook. Without a clear solution to the Greece crisis, USD/KRW could continue to trade higher in the short-term. What makes South Korea more vulnerable is its large short-term external debt although we have seen sharp improvements since the Lehman crisis. Korea's short-term foreign debt has fallen to 49% of its FX reserves at end-2Q11 from 79% in 3Q08, in part due to tougher



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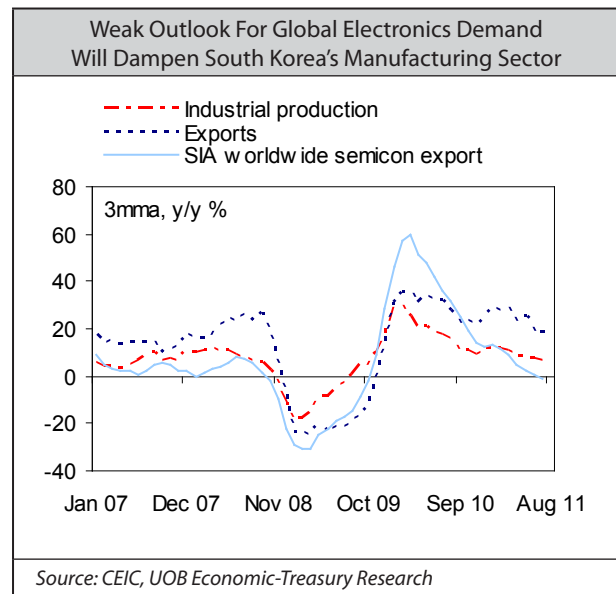
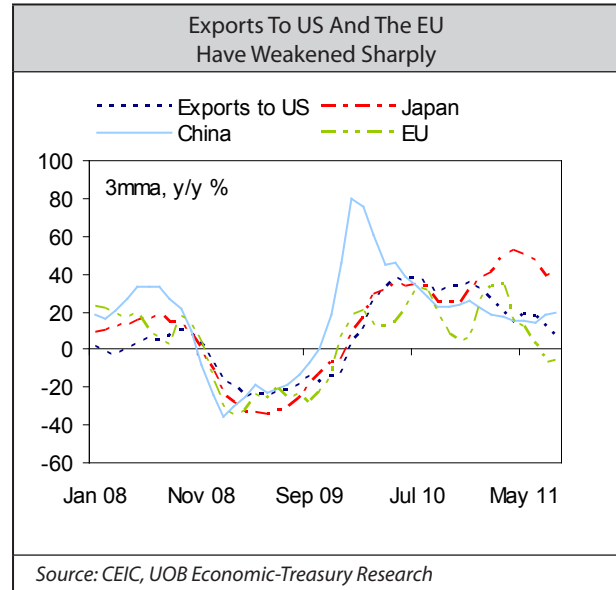
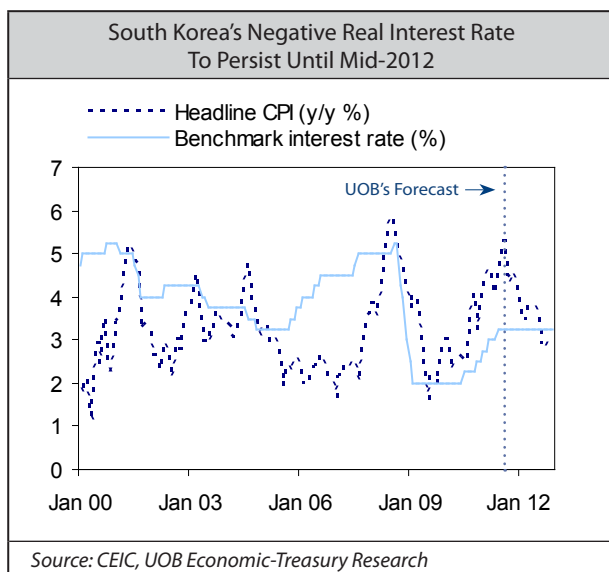
regulations on the banking sector. USD-shortage at the onshore market drove the widening of spreads between USD/KRW cross currency swap and KRW interest rate swap as evidenced in the 1Y basis swaps doubling to -250 bps from mid-2011 levels. The 10-year KTB yields also picked up as an indication of market stress as foreign money exits. Using 2008 as a comparison, we note that there is certainly more downside to the market indicators. We have raised our year-end target for USD/KRW to 1,170 but meanwhile, the pair could test higher if the 500 pips surge during the global financial crisis in 2008 is any gauge.

Market Uncertainties Keep BoK On Hold

The BoK has already normalised its base rate by 125 bps since July 2010 compared with 325 bps cut during the global financial crisis. If not for the downward spiral in the global outlook, the central bank would most likely continue to hike a further 25-50 bps in the coming months given that inflation has continued to exceed expectations. Even at its September meeting, the BoK has said that the decision to keep a steady rate was not unanimous and that the monetary policy committee members are clear about the need to continue raising interest rates to achieve price stability. The tone has weakened as the external uncertainties dragged on with the BoK now indicating it will be prudent. Given the significant increase in external risks, we are now expecting the BoK to keep its benchmark policy rate steady at 3.25% through 2012.

But Inflation Will Stay High

Although growth risks have become more apparent, inflation is also showing upside risk. We have recently lowered our GDP growth forecast to 4.2% from 4.6% (with downside risk) and raised our inflation forecast to 4.5% from 4.1%. This puts the BoK in a tight spot.



The headline inflation rate has surged to 36-month high in August at 5.3% y/y (July: 4.7%). Core inflation in the country has also been trending higher to 4.0% y/y in August from 3.8% in July and under 2.0% in 2010. Looking ahead, we do expect headline inflation to slip back below 5.0% for the rest of the year although it will likely remain above the BoK's target range of 2%-4%. For 2012, headline inflation is likely to remain near the upper end of the BoK's target range in the first half. Weaker domestic currency will be a challenge.

Despite above-trend inflation, the economic uncertainties will make it really difficult for the central bank to resume normalising rates with some speculation that Asian central banks, including the BoK could be contemplating cutting

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interest rates soon as the Eurozone crisis spreads. The government is also using other measures such as cuts to the import tariffs to contain the price pressure.

Easing Growth Is A Challenge

GDP growth in South Korea slowed to 3.4% y/y in 2Q11 from 4.2% in 1Q11. This is the slowest growth rate since 4Q09. On a s/adj basis, growth momentum eased to 0.9% q/q in the quarter from 1.3% in 1Q11. With first half growth at just 3.8% y/y, we are revising our full-year growth forecast for the country lower to 4.2% from 4.6% previously. Despite weaker global outlook, a lower base will support an acceleration of the growth rate in 2H11. We are expecting the y/y growth to rebound back above 4.0% in the next two quarters. The key risk to our forecast is the

contagion from the EU debt crisis. In its mid-year review, the BoK has also lowered its 2011 GDP growth forecast to 4.3% from 4.5% given the external uncertainties.

The main drag in 2Q11 came from weaker-than-expected exports, resulting from the slippage in June. Fixed investment has continued to contract on a y/y basis in the quarter, resulting from some easing in machinery investment growth while construction investment continued to contract amid a weak real estate market. Going forward, consumption demand will likely continue to be the key growth driver, supported by a low interest rate environment. However, investment and exports expansion will face strong headwinds from the economic and fiscal woes in US and the EU.

South Korea's GDP Growth Continued To Ease In 2Q11							
	2010	2Q10	3Q10	4Q10	1Q11	2Q11	
	y/y % change						ppt cont
Real GDP	6.2	7.5	4.4	4.7	4.2	3.4	3.4
Final Consumption	3.9	3.4	3.4	3.0	2.5	2.8	1.8
Private Consumption	4.1	3.5	3.6	2.9	2.8	3.0	1.5
Public Consumption	3.0	2.9	2.5	3.2	1.5	2.1	0.3
GFCF	7.0	6.8	6.8	3.4	-2.2	-1.1	-0.3
Construction	-1.4	-2.3	-3.1	-2.9	-11.9	-6.8	-1.1
Facilities Investment	25.0	30.5	26.6	15.9	11.7	7.5	0.8
Change In Stocks (% of GDP)	-0.7	-0.4	-1.1	-1.5	0.6	0.3	0.7
Net Exports	1.9	-1.9	-4.2	23.8	72.6	19.3	1.4
Exports	14.5	14.5	11.6	15.7	16.8	9.6	4.7
Imports	16.9	18.0	14.7	14.2	10.8	7.9	3.3

Source: CEIC, UOB Econ-Treasury Research