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Overview

Entering the fourth quarter of 2005, it was more evident that the economy was in a solid recovery. Private consumption was much stronger than had been anticipated, and exports remained strong. We forecast economic growth for 2006 at 4.7% on the back of a continued recovery in the domestic economy and further export growth. Interest rates should rise gradually, and the exchange rate should be stable. Financial institutions are expected to see higher profits as the macroeconomic environment will continue to become more favorable. The financial sector should see growth despite possible sluggishness in fixed investment.

Macroeconomic Developments

The Korean economy continues to rebound in a convincing way. The real GDP was up 4.5% y.o.y. in the third quarter of 2005, the fastest pace of the year. The accelerating pace of economic growth was mainly fueled by an upsurge in private consumption and sound export growth. Real GDP growth had accelerated in the second quarter to 3.3% y.o.y. from 2.7% in the first quarter.

The economic recovery became more apparent in the first two months of the fourth quarter of 2005. Private consumption continued to rise gradually, helped by a surge in sales of durable consumer goods. Export growth in the second half of 2005 reached 13.5% y.o.y., a rate much higher than previously anticipated. Preliminary consumption indicators such as the Monthly Consumer Goods Sales Index and Service Sector Activities Indices showed solid growth in October and November, reassuring market watchers of further improvement in private consumption.

Outlook for 2006

In 2006, the Korean economy will continue to recover soundly, approaching its potential growth rate. The annual growth rate in 2006 is forecast at 4.7%. The rally in stock prices should continue; and improvements will be seen in both household income and consumer sentiment. Real private consumption is forecast to rise 4.9% y.o.y., slightly more quickly than real GDP growth. The growth in 2006 is forecast at 4.9% in the first half and 4.6% in the second half. It will depend largely on domestic demand, which in turn will hinge on the strength
of the wealth effect of the stock market rally. In addition to strong domestic demand, the recovery will greatly benefit from strong exports, even in the face of high oil prices and a strong Korean won. While equipment investment will improve, construction spending is seen to remain weak because of the government's tough new regulations to discourage real estate speculation.

**Financial Markets**

In 2005, interest rates climbed as expectations of economic recovery returned. After dipping along with US long-term rates at the end of August, interest rates rose sharply following the BOK governor's comment on an upcoming increase in the target call rate. The won/dollar exchange rate has been relatively stable in 2005 despite the hikes in the federal funds rate. The stock market has been very strong all through the year as domestic institutional investors have purchased stocks aggressively. Investors were greatly encouraged by S&P's upgrading of Korea's sovereign credit rating, and the announcement of the government's new real-estate policy removed the uncertainty in the market, helping push equity prices higher.

Reflecting the domestic economic recovery, the M3 growth rate has ratcheted up since April. Since September, M3 growth moderated slightly as interest rates jumped. In 2005, the uncertainties concerning the prospects for the economic recovery discouraged both corporate investment and demand for money, and banks have concentrated on mortgage lending. The total volume of bank lending to the corporate sector during the period from January through November increased by 16.3 trillion KRW, but household lending was up by 27.3 trillion KRW.

As the pace of the economic recovery becomes more pronounced in 2006, long-term interest rates should rise gradually. The exchange rate is seen to drift down to around 1,000 won per US dollar on average, and the stock market should continue to trend upwards in anticipation of a stronger economic recovery and improvement in corporate earnings.

**Financial Industries**

The total assets of domestic commercial banks rose 3.4% y.o.y. Bank revenue in the first three quarters
soared 68.0%, with non-operating income leading the way. A sharp decline in loss provisions was also a factor. The banking industry in general is now more solvent as a result of improvement in the household lending and credit card debt situation as well as financial industry restructuring, which led to higher non-operating income on investment securities.

In 2006, the total assets of commercial banks are expected to increase due to the rising interest rates, but the growth may be minimal because the inflow of funds into the stock market is likely to persist due to the ongoing rally in stock prices. As the economic recovery gains strength, corporate lending is expected to rise. The soundness and capital adequacy of the commercial banks in 2006 are expected to continue improving. The delinquency ratio will naturally fall further as personal incomes rise, and the rate of late payments for unsecured loan will stay low.

Credit card companies reported positive net income for the third quarter, during which their total assets increased gradually. The delinquency ratio at the six credit card companies declined to 11.9% from 13.3% in the third quarter. The net income of mutual savings banks improved greatly in the third quarter of 2005, rising to 175.2 billion KRW, the highest level since the financial crisis. This earnings surprise was a result of strong gains on securities investments and project financing services.

Securities companies during the first half of FY 2005 (April 1 to September 30) realized a total gain of 1,544.2 billion KRW in pre-tax income, nearly three times the 595.5 billion KRW reported in the first half of FY 2004. Most of the increase was due to the higher volume of brokerage commissions earned during the boom in the stock market. The brokerage commissions on the KOSPI and KOSDAQ markets increased 33.2% to 349 trillion KRW and by 155.8% to 197 trillion KRW compared with the previous year. In 2006, the securities companies are expected to report roughly the same level of profits as in 2005.

Both the life and non-life insurance companies are expected to realize high premium income and investment profits, as in 2005, thanks largely to the implementation of the retirement pension system, greater demand for variable life insurance and long-term non-life policies, the rally in stock prices, and unrealized gains on derivatives.
Current Issues

This issue of the *Korean Economic and Financial Review* includes five short papers on current economic policy issues. The first paper analyzes universal banking, which has become of great interest in Korea since the financial sector restructuring of 1997. Each type of financial institution must be permitted to engage in certain, specific financial services and activities. The paper concludes that the core businesses of each sector in the financial industry should be reduced to the minimum and that financial institutions should be permitted to engage in as many financial services and activities as possible, and these changes should be made as soon as possible. Financial institutions should list and clarify their core businesses and then reestablish the concepts of both subsidiaries' financial activities and in-house financial activities according to the concept of the core business.

The second paper examines the profit sustainability of Korean banks, especially with regard to the banks' strategies for diversification of income streams. The third paper addresses the amendment of the Financial Industry Restructuring Act (FIRA) of Korea, which has been in effect since March 1997. The central issue of the amendment is whether the financial supervisory authorities can retroactively enforce regulations against a financial institution or affiliated financial institution that possesses or maintains a holding of another firm's stock that is over the limit prescribed by the FIRA (esp. Article 24), which also addresses ex-post approval, voting right restrictions, and disposal of the stock etc.

The fourth paper looks at ways to address the population aging problem in Korea. While Korea is experiencing very rapid aging compared to nearly every other developed country, the social safety net for senior citizens is still very inadequate. This paper suggests that the retirement pension system and the reverse mortgage system should be fully institutionalized. The fifth paper analyzes the effects of the economic recovery of Japan on the movement of the yen/dollar exchange rate. It concludes that once the issue of the interest rate gap between the US and Japan fades away in the near future, the yen/dollar rate will start to decline. Recent developments in the foreign exchange market already seem reflect this change.
The Korean economy continues to recover strongly. The real GDP grew 4.5% y.o.y. in the third quarter of 2005, the strongest pace for the year. The accelerating pace of economic growth was largely fueled by an upsurge in private consumption. Private consumption is finally picking up after ending a two-year slowdown since the household debt crisis in 2003. Strong export growth of 13.5% in the second half was also a significant factor. Investment, however, is still not showing any indication of rebounding. The real GDP growth rate in 2006 is forecast at 4.7% y.o.y. It will nevertheless be some time before consumer sentiment fully rebounds because growth in real GNI is being held back by the high oil prices. Real private consumption is forecast to rise 4.9% y.o.y., slightly more quickly than real economic growth, which means that the pace of economic growth will depend heavily on private consumption. While equipment investment will improve, construction spending is seen to remain weak because of the government’s tough new regulations to discourage real estate speculation. Export growth will remain strong, despite the strong Korean won and high oil prices.

A. Demand and Supply

A.1 Aggregate Demand

The Korean economy continues to recover soundly. It has shown signs of strength after growing only 3.0% y.o.y. in the first half of 2005. In the third quarter, the real GDP growth rose 4.5% y.o.y., driven by the recovery in domestic demand, especially private consumption. Private consumption was up 4.0% y.o.y., which was 1.2%p higher than the 2.8% y.o.y rate of the previous quarter. Construction investment increased only 0.4% y.o.y. (Table A.1). Naturally, the share of private consumption in real GDP increased by 2.0%p in third quarter, after rising 1.4%p in the second quarter. The contribution of construction spending fell 0.1%p in the third quarter (Table A.2).

With the recent recovery in domestic demand and exports, domestic and export shipments increased sharply by 6.7% and 14.0% in November. In the previous month, they were up 2.7% and 10.7% (Figure A.1). The stronger domestic demand helped push industrial production up (10.2% y.o.y. in October and November) at a faster rate than in the previous quarter (6.9% y.o.y. in the third quarter) (Figure A.2).

The rise in private consumption is increasingly being felt throughout the entire economy. Increases have been seen in both durable goods and services.
Durable goods sales in November soared 9.8% y.o.y., led by automobiles and computers. They had been up only 0.8% y.o.y. in the previous month.

The Korean economy is now approaching its growth potential. However, weakness in investment and household income growth is expected to temper the recovery in private consumption. Furthermore, stagnation in the real GNI and the increasing disparities in the economy and income distribution over the past several years have prevented the low-income groups from benefiting from the economic recovery and have soured market sentiment.

**Economic Growth**

The Korean economy entered the last recession in the second quarter of 2004 and is believed to have bottomed out in the second quarter of 2005. The GDP grew 4.5% y.o.y. in the third quarter, the strongest rate for the year.

The growth is seen to have continued through the fourth quarter of 2005, fueled by the gradual rise in wholesale and retail sales and the resilience of service sector activity. Service sector output rose 5.3% y.o.y. in October and November (Figure A.3). Wholesale and retail sales in November rose 4.0% from a year earlier and 2.0% from the previous month.

Despite the economic recovery, the weakness in equipment investment may hinder the capital accumulation required to maintain the potential growth rate.

Export growth in 2005 decelerated rather dramatically on a technical basis, but it was still strong in the light of the extremely high increase of 31.0% for the previous year. Despite concerns over high oil prices, export growth turned substantially upward in the second half of 2005. In the first half, export (f.o.b.) growth fell to 10.8% y.o.y. from 24.7% in the previous half. In the second half, it rose to 13.5% y.o.y., benefiting from the stable growth of world economy. The US economy had been expected to slow down in the second half of 2005 owing to the spike in oil prices and the two major hurricanes. The Chinese economy has also remained strong and has boosted Korean exports. This bodes well for the near future as exports and domestic demand have
been the major drivers of the recovery in the Korean economy.

In terms of the Korean won, real exports of goods and services in the third quarter rose 11.5% y.o.y., while real imports rose 10.7% (Table A.1). Net exports contributed 1.3%p to economic growth, which was about one-third of the real GDP growth in the period (Table A.2).

In the first half, real exports rose only 6.4% y.o.y., as compared to 19.7% y.o.y. in 2004. Although the share of net exports in real GDP has already become smaller than the consumption share, the recovery in export growth should contribute significantly to economic growth in the following year.

### A.1.1 Domestic Demand

Domestic demand has been accelerating gradually since the second quarter, putting an end to two years of stagnation. With the considerable progress that has been made in the household debt situation, coupled with the gradual improvement in the job market, private consumption showed strong signs of improvement. It rose 4.0% in the third quarter of 2005 and made the largest contribution of any expenditure components of real GDP (Figure A.4). The 2.1% increase rate and 1.1%p contribution to the real GDP growth rate in the first half of 2005 are clear indicators that private consumption is indeed recovering.

This, to be sure, is a positive change, but fixed investment remains weak. It increased only 2.0% in the third quarter of 2005, which was slightly lower than the 2.1% rate in the previous quarter. The contribution of equipment investment to the economic growth rate was neatly flat around about 0.3%p throughout the year.

In the third quarter of 2005, real GDP growth accelerated to 4.5% y.o.y. from 3.3% y.o.y. in the second quarter. The fact that private consumption finally picked up was very encouraging, especially since it had contracted over a period of two years, since the household debt crisis in 2003. Various consumption indicators show steady improvement in the second half of 2005, and the Korean economy is likely to have expanded in the high 4% range in the fourth quarter, nearing its growth potential.

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**Table A.2 Contributions to Real GDP Growth**

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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<td>Year</td>
</tr>
<tr>
<td>GDP</td>
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<td>4.6</td>
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<tr>
<td>Consumption</td>
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<td>0.1</td>
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<tr>
<td>Private</td>
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<td>△0.3</td>
</tr>
<tr>
<td>Government</td>
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<td>0.4</td>
</tr>
<tr>
<td>Investment</td>
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<td>0.6</td>
</tr>
<tr>
<td>Construction</td>
<td>△0.7</td>
<td>0.2</td>
</tr>
<tr>
<td>Equipment</td>
<td>0.3</td>
<td>0.4</td>
</tr>
<tr>
<td>Inventories</td>
<td>2.6</td>
<td>△0.2</td>
</tr>
<tr>
<td>Net Exports</td>
<td>0.2</td>
<td>3.6</td>
</tr>
</tbody>
</table>

**Notes:**
1) Contribution Rate = Change in each factor / Change in GDP × GDP growth rate
2) Percentage changes from previous year.
Construction spending was up only 0.4% y.o.y. as construction activity declined. Although equipment investment rose to 4.2% y.o.y. in the third quarter after rising 3.3% in the previous quarter, its recovery is still negligible.

**Private Consumption**

The pace of the recovery in private consumption accelerated gradually through 2005, after bottoming out in the fourth quarter of 2004. In the second half of 2005, it increased at a rate of over 4%, led by sales of durable goods and services. In the fourth quarter, there have been a number of indications of a continued acceleration in private consumption.

Consumer goods sales growth accelerated to 5.9% y.o.y. in November from 3.7% in October (Figure A.6), driven by strong sales of durable and non-durable goods. Nominal expenditures on durable goods, which are a strong indicator of future fluctuations in aggregate consumption, increased 0.8% and 9.8% respectively in October and November from a 0.8% decline in September. Consumption of non-durable goods also bottomed out, rising 2.5% and 3.4% y.o.y. in October and November, after falling 1.3% y.o.y. in September.

Wholesale and retail sales in the service sector rose 1.3% and 4.0% y.o.y. in October and November (Table A.3), driven by a recovery in auto sales and gains in the sales of vehicle fuels, which increased 9.3% and 28.4% y.o.y. in November. Consumer spending rose steadily in November given the upturn in preliminary consumption indicators including retail sales and credit card use and the improved consumer confidence (Figure A.6). Sales growth at both department and discount stores continued to rise and were up 2.9% and 8.3% y.o.y. in November. Credit card purchases increased 19.1% and 18.3% y.o.y. in October and November.

Private consumption is forecast to rise further given the improvement in the household debt situation and rising employment. The wealth effect of rising stock prices will likely bolster consumer sentiment and real consumption, though the poor income conditions as indicated by the slowing growth in real household income (urban workers) and Gross National Income (GNI), which are measures of real purchasing power of the national economy, may serve to restrain the rebound in private consumption. In the third quarter
of 2005, the growth rates of real household income (urban employees) and real GNI rose to only 0.6% and 0.1% y.o.y., in spite of the strong 4.5% real GDP growth in the same period (Figure A.8).

**Fixed Investment**

Pulled by the 4.1% y.o.y. increase in total consumption, fixed investment rose 2.0% y.o.y. in the third quarter of 2005 (Table A.1). Equipment investment growth accelerated to 4.2% from 2.9% in the second quarter; construction investment growth fell to 0.4% y.o.y. from 1.7%.

The estimated equipment investment index (current value) in October and November rebounded, posting 1.7% and 6.9% increases y.o.y. with the rise in machinery and transportation equipment investment. Other equipment investment indicators also rebounded in November. Domestic shipments of machinery increased 1.7% from the previous year. As a leading indicator of equipment investment, domestic machinery orders increased sharply by 11.8% y.o.y. in November, overcoming last month's sluggishness of only 0.9% y.o.y.

The manufacturing sector's capacity utilization rate has recently been quite high. During January∼November of 2005, it rose to about 79.8%. This is more than 1.3%p higher than the average for the past 15 years and is comparable to rates recorded during economic booms in the past. Despite the increased investment pressure, equipment investment did not increased as much as in past booms. This is likely due to the inclination that companies have improved their competitiveness through rationalization and R&D investment rather than expanding production capacity.

In December, the Business Survey Index (BSI) from Federal Korean Industries (FKI), which indicates business confidence in the Korean economy, was above the base figure of 100 for a fourth consecutive month (Figure A.11). For this reason, equipment investment is expected to rise steadily with the recovery in demand, but strong improvement is not likely for the time being considering companies' recent investment behavior. If equipment investment does not increase significantly in 2006, economic growth is hardly likely to reach the potential growth level.
Although the pace of construction investment on the national accounts slowed to only 0.4% y.o.y. in the third quarter of 2005 from 1.7% in the last quarter, the increase rate of the construction investment index (current value) rose in October and November. The current value of completed projects rose 3.6% and 11.0% y.o.y. in October and November, after rising 3.3% in September (Figure A.11). Private construction investment soared 17.5% y.o.y. in November, despite a contraction of 3.2% in public construction investment.

In discussing the movement of construction investment in 2006, we have to consider the anticipated impact of the new real estate restrictions passed by the Korean National Assembly on December 30, 2005. The Korean government has shown that it is determined to curb real estate speculation, and this likely precludes any quick recovery in construction this next year.

The fact that the Korean monetary authorities raised the target call rate to 3.75% in December of 2005 (Figure A.12) will also negatively impact the real estate market, and in turn, construction investment.

### A.1.2 External Demand and the Balance of Payments

The global economy continued to show a solid performance in the third quarter of 2005. GDP growth of the major economies indicated that the economic expansion would be sustained. The US economy expanded at a 3.8% rate y.o.y. in the third quarter due to a strong pick-up in the residential real estate market. The Eurozone shrugged off its sluggish growth in recent quarters and managed to expand 0.6% y.o.y. in the third quarter thanks to stronger exports.

In contrast with the US and the Eurozone, Japan slowed to 0.4% y.o.y. growth in the third quarter due to a minimal increase in private investment. China expanded at the 9.4% rate y.o.y. in the third quarter and is expected to keep up this pace in the fourth quarter as well. The strong growth all around the world naturally meant strong demand for Korean products. The current account surplus year-to-date reached $112.3 billion (Table A.4).
The balance of payments hit a new record in the third quarter of 2005 despite concerns over the strengthening of the won. The third quarter balance of payments totaled $6.8 billion, compared to $7.6 billion in the same period of last year. Exports rose 15.4% y.o.y. in the third quarter, sharply reversing a 28.9% rise y.o.y. from last year, and imports increased 20.7% y.o.y., compared to a 27.3% rise y.o.y. last year (Table A.4).

China remains the major source of the surplus, followed by the EU and the US. The trade deficit with the Middle East surpassed that with Japan for the third consecutive quarter due to the high oil prices. The trade surplus with the EU swelled to $3.4 billion in the third quarter, compared to $3.0 billion in the same period last year. The trade surplus with Latin America rose more than $0.7 billion y.o.y. to $1.2 billion. In sum, increases in the trade balance were seen with China, ASEAN, the EU, and Latin America, and deteriorations were seen with the US and the Middle East (Table A.5).

There was significant change in the composition of Korea’s exports. Computer exports declined steadily throughout the year. Export growth of motors decelerated to 12.1% from 39% last year. Machinery, steel, and petrochemicals continue to lead the export growth, rising at rates of over 20%, while mobile equipment has risen at a relatively slow rate of 5.5%, which compares starkly with 40.3% in 2004 (Table A.6).

### A.2 Aggregate Supply

#### Potential Growth Rate

The smoothed real GDP growth rates (Figure A.13) suggest that the potential growth rate of the Korean economy has declined over the last several decades. This is mainly due to a slowdown in input growth as the growth rate of GDP per worker has not declined as much as total GDP growth. In the post-crisis period, it is not at all obvious that the potential growth rate has steadily fallen.
Total Factor Productivity

Total factor productivity has been rising steadily in recent years. Growth accounting analysis using the Cobb-Douglas production function with human capital shows that 26.6% (1.44%p) of real GDP growth during the last five years was from productivity gains, which is higher than 20.5% for the ten years from 1987 to 1996 (Table A.7).

R&D intensity (R&D expenditures as a percentage of GDP), one of the most important determinants of TFP growth, has been rising steadily, reaching 2.85% in 2004 (Figure A.14). This level of R&D intensity is comparable to those of major industrial countries, which shows that as long as R&D is conducted efficiently, TFP growth will remain robust.

Labor Input and Human Capital

The contribution of the labor input to economic growth in 2000 to 2004 period was 1.50%p on average each year, roughly 0.6%p lower than 2.11%p in the 1987 to 1996 period. Most of this slowdown can be accounted for by the declining growth rate of the labor force, i.e., the economically active population (Figure A.15).

The quality of the labor force, measured in terms of average years of schooling, has improved over time, but at a decelerating rate (Figure A.15). The contribution of the quality of labor input to economic growth in the 2000 to 2004 period was 0.66%p on average each year, 0.28%p lower than 0.94%p in the 1987 to 1996 period. Most of this slowdown simply reflects the fact that the educational attainment has entered a mature stage of development.

Physical Capital

The slowdown in physical capital input growth in recent years has been much more pronounced than that of either the labor input or human capital. The contribution of physical capital to economic growth in 2000 to 2004 period was 1.81%p on average each year, about 1.8%p lower than 3.62%p in the 1987 to 1996 period.

From a long-run perspective, a general slowdown in the rate of capital accumulation would not be unexpected in a developing country that has
experienced several decades of rapid growth. Unlike advanced countries, the capital-output ratio had been rising until 1998, implying that many investment opportunities have dried up only recently (Figure A.16).

Since 1998, however, the rate of investment has been far below the rate of return, indicating the possibility of under-investment, which compares starkly with the over-investment of the pre-crisis years. The net return from aggregate investment last year alone was 7.9% of nominal GDP, the second highest since 1981. This implies that the lower rates of investment and capital accumulation are not permanent phenomena.

B. Inflation

B.1 Oil and Import Prices

Oil prices rose sharply throughout 2005 and peaked on September 1 at over US$ 70 per barrel. During the first eight months of the year, the rise was fueled by high global liquidity and low interest rates, and this in turn gave way to speculation. Other significant factors were bottlenecks in refining capacity and political instability in the Middle East, and expectations that demand for oil will continue to increase due to expansion of the Chinese and world economies.

Speculation became more intense in July and August because of low US oil inventories, and the situation became even worse when US Gulf Coast refineries suffered hurricane damage. Oil prices went on a climactic surge and set a new record on September 1. Prices then fell back as a result of shifts in demand for oil and a pledge by OPEC to increase oil production (Figure B.1). On December 29, Dubai crude was trading at US$ 52.96 per barrel; Brent crude was at US$ 57.74; and WTI was at US$ 60.32.

The price of Dubai crude, which accounts for about 80% of Korea's oil imports, rose 48.0% y.o.y. in the fourth quarter. This should have caused significant cost-push inflation, which would have been a heavy burden on the economy. However, the inflationary pressure was countered to a significant degree by the 5.1% decline in the won/dollar exchange rate in the fourth quarter and reduced domestic demand.
As a result of the surge in crude oil prices, unit import prices in the third quarter increased 9.3% y.o.y. and lowered the terms of trade by 7.4% y.o.y. (Figure B.2). The rate of increase in import prices in the third quarter was only 4.0% y.o.y. due to the 10.9% appreciation of the Korean won against the U.S. dollar (Figure B.3) and a 5.8% decline in the import prices of intermediate capital goods (Figure B.4). In October and November, the import price index rose 3.1% and 5.6% y.o.y. respectively (Figure B.4) as the prices of imported raw materials increased.

**B.2 Domestic Inflation**

**Producer Prices**

The Producer Price Index (PPI) rose 6.1% in 2004, but rose only 2.2% and 1.7% y.o.y. in the second and third quarters or 2005. Import prices and agricultural prices had stabilized, and domestic demand was still sluggish. In October and November, the PPI inflation rate declined further to 1.6% and then to 1.1% y.o.y. owing in large part to declines of 1.9% and 5.3% y.o.y. in agricultural, forestry, and fisheries prices in addition to stability in prices of industrial products (Table B.1).

**Consumer Prices**

The Consumer Price Index (CPI) rate fell gradually to 2.4% y.o.y. in the third quarter, mainly due to the stability in agricultural prices and service charges, and it stayed at 2.4% y.o.y. in November (Figure B.5). The 9.6% y.o.y. increase in oil product prices in the third quarter has not yet completely translated into CPI inflation.

The average CPI inflation rate for the period between January and November was 2.8% y.o.y., which is 0.8%p lower than 2004's annual rate of 3.6%. Prices of agricultural products, livestock, and fishery products contributed only 0.2%p, compared to 0.97%p in 2004 (Figure B.6). Housing rents and private service prices also rose only slightly.

Core Inflation, which excludes products that experience exogenous price movements, such as agricultural and energy products, fell in the fourth quarter to 1.8%. This is indeed below the lower bound of the Bank of Korea's target inflation rate.
range of 2.5% to 3.5%, but there is no reason to believe that this will influence the BOK’s next decision on the call rate, especially as the target inflation rate range is already rather wide.

### Nominal Wages

Following the slow but expected recovery of the economy, nominal wages in 2005 rose at a slightly higher rate than in 2004. Nominal wages in the non-farm private sector increased 6.7% y.o.y. in the first three quarters, compared to 5.5% in 2004.

Annual real wages, which are deflated by the CPI inflation rate, rose 4.4% and 3.0% y.o.y. in the second and third quarters, compared to 2.8% on average in 2004.

Labor productivity growth, defined as the increase in GDP per employee in the non-farm private sector, had not picked up much in 2003 and 2004 and edged up only 1.9% y.o.y. in the first three quarters of 2005, 0.6%p lower than the 2.5% rate in the same period of 2004 (Figure B.7).

### C. Macroeconomic Outlook for 2006

#### C.1 Global Economy and Balance of Payments

The world economy is expected to continue growing solidly in 2006. There will likely be a slight slowdown in China, but Japan is showing positive signs. Major international forecasters have slightly revised upwards their growth outlooks of the main economies.

The US economy is expected to grow 3.5% in 2006. Corporate investment should increase, and government spending will rise for reconstruction in areas hit by Hurricane Katrina. Growth in China is set for another year of high growth, though growth is expected to be contained below 8%. Japan will continue to rebound from its more than decade-long recession and grow about 2%. The Eurozone is also expected to experience a recovery and grow 1.8% due to strong growth in domestic consumption and improvement in labor market conditions. The BRIC countries (Brazil, Russia, India, and China) are

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**Table B.1 CPI and PPI**

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
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</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>2Q</td>
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<tr>
<td>CPI</td>
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<td>Agricultural and Fisheries</td>
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<tr>
<td>Industrial</td>
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<td>3.7</td>
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<tr>
<td>Service</td>
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<td>2.4</td>
</tr>
<tr>
<td>PPI</td>
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<td>2.2</td>
</tr>
<tr>
<td>Agricultural, Forestry &amp; Fisheries</td>
<td>12.1</td>
<td>△2.4</td>
</tr>
<tr>
<td>Industrial</td>
<td>7.5</td>
<td>3.1</td>
</tr>
</tbody>
</table>

Source: The Bank of Korea.
Table C.1 Economic Outlook for Major Trade Partner Countries

<table>
<thead>
<tr>
<th>Countries</th>
<th>IMF</th>
<th>OECD</th>
<th>JPM</th>
<th>Goldman Sachs</th>
<th>Morgan Stanley</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S.</td>
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<td>3.5</td>
<td>3.4</td>
<td>3.6</td>
<td>3.5</td>
</tr>
<tr>
<td>China</td>
<td>8.2</td>
<td>9.4</td>
<td>8.5</td>
<td>9.0</td>
<td>6.7</td>
</tr>
<tr>
<td>Japan</td>
<td>2.0</td>
<td>2.0</td>
<td>2.5</td>
<td>2.4</td>
<td>2.5</td>
</tr>
<tr>
<td>Euro</td>
<td>1.8</td>
<td>2.1</td>
<td>1.8</td>
<td>1.7</td>
<td>1.7</td>
</tr>
</tbody>
</table>

Source: IMF ('05.9); OECD ('05.12); IB ('05.11).

A surplus of $14.0 billion is forecast for the balance of payments in 2006. This is a slightly over 75% of the projected $18.0 billion surplus for 2005. Factors limiting the surplus will be the chronic deficit in the service account, possible further revaluation of the Chinese yuan, and high energy and raw materials prices.

C.2 Economic Growth

The Korean economy is actually expected to approach its potential growth rate in 2006. In addition to stronger domestic demand, the recovery will benefit greatly from strong exports, even despite the high oil prices. The appreciation of the Korean won and slack domestic investment will pose downside risks as in 2006, however.

Exports should post another year of solid growth in 2006, helped mainly by the continued expansion of the world economy, especially the Chinese economy. Furthermore, the improvement in the labor market may spur greater consumption and improve income distribution.

Despite the economic recovery, some aspects of the recent economic trends raise concerns in view of building growth potential. The stagnation in equipment investment may hinder the capital accumulation required to maintain the potential growth rate at its current level.

Both the Coincident Composite Indicator (CCI) and Composite Leading Indicator (CLI) continued to rise through November, marking seven consecutive months of increase (Figure C.1), suggesting that the Korean economy was recovering steadily throughout the year.

Gross Domestic Production

We expect the Korean economy to approach its potential growth rate in 2006. The growth in 2006 will depend largely on domestic demand, which in turn will hinge on the strength of the wealth effect of the rising stock prices as well as the improvement in household income and consumer sentiment.
It should be noted the fact that the rates of growth in personal disposal income have been below those of national disposal income indicates the possibility that the recovery in consumption may not be sustainable. In addition, weak spending by lower income households is likely to delay any full recovery in consumption.

For 2006, the Korean economy is forecast to grow 4.7% on the back of a mild recovery in the domestic economy and strong exports, supported by solid growth in the world economy. This would be a significant acceleration from 3.9% growth in 2005. Growth in the first half is forecast at 4.9%, and growth in the second half should be about 4.5%. The contribution to growth in 2006 from consumption should rise to 2.8%p from 1.9%p in 2005. Exports will likely maintain double-digit growth, but will contribute less to GDP growth. As a result, the long-standing imbalance between strong exports and weak domestic demand will undergo a steady correction, and the Korean economy will be in better shape than it has been for several years.

### Private Consumption

Private consumption has accelerated since the fourth quarter of 2004, led by strong consumption of durable goods including automobiles. Private consumption growth was just 2.1% y.o.y. in the first half of 2005, but it picked up to an estimated 4.3% y.o.y. in the second half. The improvement in employment and the wealth effect from rising stock prices will bolster private consumption even more in 2006, and the contribution of private consumption to economic growth should naturally be higher than in 2005.

Although private consumption is expected to rise, there are some risk factors. The growth in personal disposal income has been below that of the national disposal income, indicating the possibility that the current recovery in consumption may not be sustainable. The slowdown in GNI growth and the strong won have hurt corporate profits, and this has reduced personal income.

Real private consumption is forecast to rise 4.9% in 2006, slightly more rapidly than real economic
annual real GDP growth (Table C.3 and Table C.4).

**Fixed Investment**

In 2006, fixed investment is seen to rise 3.4%. Equipment investment should rise 6.2%, a slightly higher rate than in 2005, and construction investment should rise 2.0%.

The stronger equipment investment growth should benefit the recovery in domestic demand in 2006. The global IT industry is expected to bottom out in the first quarter of 2006, so there should be more equipment investment in this industry soon. Although the monthly equipment investment indexes have not shown any indication of a strong recovery (Figure C.4), we expect them to improve somewhat in the near future.

Considering the macroeconomic conditions such as the low real interest rates and strong corporate profits, we expect equipment investment to increase modestly but steadily in 2006 with the recovery in domestic demand. A strong improvement is unlikely for the time being given the significant decline in machinery orders. We forecast equipment investment to rise 7.2% y.o.y. in the second half and 6.2% for the entire year, contributing 0.6%p to real GDP growth (Table C.3 and Table C.4).

Despite an increase in public sector construction investment, private sector construction investment will rise at a slower rate in 2006. There is no reason to expect a quick rebound soon, and it is likely to remain weak for some time due to the housing slowdown. There can be no doubt that the new real estate policy against real estate speculation has had negative impact on construction investment.

Construction investment should, nevertheless, inch up because so many different projects are being pursued for balanced national development and the government plans to relocate the capital. For all of 2006, construction investment is forecast rise about 2.0%.

**C.3 Inflation**

CPI inflation in 2006 is forecast at 3.0%, slightly higher than 2.8% in 2005. Most inflationary pressure will likely be due to demand-pull inflation. Prices of...
Forecast (Units: %, y.o.y.)

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1Q</td>
<td>2Q</td>
</tr>
<tr>
<td>M3</td>
<td>6.2</td>
<td>6.9</td>
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<tr>
<td>CPI</td>
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<td>2.8</td>
</tr>
<tr>
<td>PPI</td>
<td>2.4</td>
<td>3.8</td>
</tr>
</tbody>
</table>

Source: The Bank of Korea.

services will naturally rise if the economy gains strength as expected, and prices for agricultural products will not likely be so contained as they were in 2005.

The PPI inflation rate in 2006 is forecast at 2.8%, which is likewise slightly higher than the 2.4% rate of 2005. Much of the possible inflationary pressure from high oil prices should be offset by the appreciation of the Korean won.
In 2006, Interest rates should rise gradually as the economic recovery gains momentum. The exchange rate is expected to drift down to around 1,000 Korean won per US dollar on average, and the stock market should continue to trend upwards in anticipation of a stronger economic recovery and improvement in corporate earnings. The total assets of commercial banks are expected to increase due to the rising interest rates, but the growth may be minimal because the inflow of funds into the stock market is likely to persist due to the rising stock prices. The securities companies are expected to report roughly the same level of profits as in 2005, due to the higher volume of brokerage commissions earned during the stock market rally. Insurance companies will realize high premium income and investment profits, as in 2005, thanks largely to the implementation of the retirement pension system, greater demand for variable life insurance and long-term non-life policies, the rally in stock prices, and unrealized gains on derivatives.

A. Asset Prices

A.1 Changes in Asset Prices

Interest Rates

Bond yields marked a steady decline in 2004 but rose dramatically at the beginning of 2005 in expectation of the economic recovery. The government's announcement on January 3 that it would increase issuance of treasury bonds was also a factor. The benchmark three-year treasury bond and three-year corporate bond (AA-) yields surged from 3.34 percent and 3.80 percent on January 5 to 4.46 percent and 4.90 percent on February 11. In mid-February, interest rates then reversed because of declining expectations of a meaningful economic recovery, the BOK's sustained low interest policy, and the decline in US interest rates.

Interest rates began to rise again due to concerns about the real estate market. The drastic rise in housing prices in areas such as Kangnam and Pangyo spilled over into other areas in Seoul and the metropolitan area. The BOK was expected to raise its target call rate since it made clear its concern over speculation in the real estate market. The upward movement in interest rates was further accelerated by the rise in stock prices and renewed anticipation of an economic recovery in the second half. Expectations of a solid economic recovery were rekindled in this period because the rate of increase in the Service Industry Activity Index had been gradually rising.
Immediately after the regular monthly meeting of the Monetary Policy Committee (MPC) of the BOK on September 8, the governor of the BOK strongly indicated that the target call rate would be raised in October. All market interest rates began to rise on the heels of his remarks. Even short-term interest rates rose sharply in expectation of a 0.25%p increase in the target call rate in October (Figure A.3). This was unprecedented for short-term rates as they used to follow, not lead, changes in the target call rate. From September 7 to the end of the month, market rates rose by more than 0.25%p.

The three-year treasury bond and three-year corporate bond (AA-) yields increased by 0.33%p and 0.34%p, and the yields on CDs (91 days) and CPs (91 days) increased by 0.38%p and 0.46%p, respectively. Given this seeming overshooting in the interest rates, it would appear that the bond market expects further increases in the target call rate after the 0.25%p increase in October.

The BOK raised the target call rate again to 3.75 percent in December. Though it was unexpected, unlike the increase in October, the market interest rates did not move sharply because BOK Governor Park had given some indication that the target call rate would not likely be raised aggressively in the coming months. He stated that the rate was approaching the neutral level. At the end of 2005, the three-year treasury bond and three-year corporate bond (AA-) yields were 5.08 percent and 5.52 percent.

The Federal Funds Rate (FFR) of the US is another factor that should be watched carefully in considering the future movements of the target call rate. The US FFR is now 4.00 percent and is higher than the target call rate, 3.75 percent. However, the US long-term interest rates are below domestic rates, mainly because of the flattening in the US yield curve (Figure A.5). This is a rare condition, so the US FFR should not have much effect on the BOK’s target call rate.

**Exchange Rate**

The won/dollar exchange rate began another decline in January due to the chronic current account deficit of the US and talks of revaluation of the Chinese
yuan, but the decline halted in late February. The dollar began to climb back after the Fed raised interest rates in late March and traded within a narrow range before it started to decline again in late April when the Chinese yuan issue re-emerged. The exchange rate reached its low of the year of 998.20 on April 27. After some period of range-bound trading it began to rise on growing expectations of additional Fed interest rate hikes and prospects of higher oil prices. It marked its year high of 1053.80 on July 9.

The won/dollar drifted down afterward and then began to fall off at an accelerated pace when the Chinese finally allowed a 2% revaluation of the yuan on July 21. The decline proved short-lived, however, when talk of Fed interest rate hikes resurfaced and the Fed actually increased rates on August 9th and September 20th.

The won/dollar rate marked an intermediate top on October 25th. Shortly afterwards, a record trade surplus was reported, and there was speculation of further revaluation of the Chinese yuan and a possible shift in Fed policy. Although the Fed had boosted interest rates 13 times consecutively since June 2004, the Fed signaled on December 13 that further monetary tightening would likely be more measured.

Stock Prices

The stock market in 2005 opened at 893.71 points and closed at 1,379.37 points. There were several risk factors, including high oil prices, the North Korean nuclear threat, revaluation of the Chinese yuan, and the possibility of profit-taking by foreign investors. However, the positive factors were, obviously, much stronger. These included the high market liquidity owing to individual investors’ preference for indirect investments, an increase in net buying by institutional investors, and a decline in the supply of stocks because of many companies’ stock purchases and their preference for indirect financing (Figure 7).

Foreign investors bought Korean equities heavily in the beginning of 2005. A huge volume of foreign funds flowed into Asian stock markets and showed particular interest in bluechip companies, which had been undervalued. When the KOSPI rose above
1,000 points, however, foreign investors became more skittish and started to sell. Their total net purchase in the year through the third quarter was just 150.6 billion KRW. In the first three quarters of 2004, their total net purchase was 310.6 billion KRW. Institutional investors were net purchasers through all three quarters. Investors were most interested in indirect investments and participated in the stock market in greater numbers than ever before, pushing stock prices up further (Table 1).

### A.2 Outlook for 2006

#### Interest Rates

As the domestic economic recovery gains more strength and inflationary pressure builds in 2006, interest rates should rise. The treasury bond (three-year) and corporate bond (AA-, three-year) yields are expected to rise to around 5.2 percent and 5.7 percent on average. Though the target call rate may be raised one or two more times, perhaps in the first half, any further increase in the rate would be difficult, considering the gradual pace of the economic recovery.

There is also a possibility of a decline in interest rates late next year. Optimistic expectations of economic growth may reverse, considering the slow pace of increase in employment and a possible deceleration in export growth. In addition, if market participants expect that there will be no more hikes in the target call rate, funds will likely flow into the bond market, causing market interest rates to rise.

#### Exchange Rate

The won/dollar rate is expected to be fairly stable with a downward bias and is predicted to drift down and fluctuate around the 1,000 level on average during the year. Downward risks to the won/dollar rate would be a Fed decision to stop raising interest rates, increased foreign investment in Korea due to expectations of higher stock prices, stronger than expected export growth, renewed concern over the twin deficits in the US, and a possibility of further revaluation of the Chinese Yuan. Any decline in the won/dollar rate may be limited by further increases in US interest rates by the Fed, weak growth of the Korean economy, and another spike in energy prices.
Stock Prices

The stock market in 2006 will trend upwards. The domestic economy is predicted to grow despite a slight slowdown in the world economy. Furthermore, institutional investors in the stock market are expected to continue buying. Funds are expected to flow out of real estate and banks accounts and into the stock market.

B. Money and Credit

In the fourth quarter, the monetary aggregates rose at a higher rate than in the first half of 2005, reflecting the pick-up in the domestic economic recovery and domestic credit.

Monetary Aggregates

In the third quarter, the M3 growth rate rose 0.7%p to 6.4% y.o.y. It was 6.2% y.o.y. in October and around 6.5% y.o.y in November (Figure B.1). During this time, there was a sizable increase in the money supply from the domestic sector and from the overseas sector as a result of overseas bond issuances and foreign portfolio investment in the stock market.

The M2 growth rate jumped from 5.7% in the second quarter to 6.6% y.o.y. in the third quarter. In October, the M2 growth rate declined slightly to 6.3% and settled between 6.0% and 6.5% in November.

The M1 growth rate in October was 9.8%, well below the average of 12.9% in the third quarter (Figure B.1). This sharp decline in the M1 growth rate was seemingly due to a surge in time deposits and equity funds, but the M1 growth rate is still high. The Bank of Korea estimates that the M1 growth rate in November was 8.7−8.9% y.o.y., which is higher than 2003 (6.9%) and 2004 (8.1%).

The Reserve Money (RM) growth rate was 6.1% y.o.y. in the third quarter and remained high in the fourth quarter. The RM growth rate was 5.2% and 5.7% y.o.y. in October and November, respectively. Most of the growth was from the overseas sector and the private sector.
Net issuance of Monetary Stabilization Bonds (MSBs) from January through November totaled 13.7 trillion KRW, which was substantially lower than the 30.6 trillion KRW in issuance in the same period of 2004. In 2005, the BOK largely refused to intervene in the foreign exchange market owing to mounting concerns over the opportunity cost of excessive accumulations of foreign reserves.

For this reason, the volume of foreign reserves did not rise as fast as in previous years (Figure B.2), i.e. the BOK did not purchase foreign currencies, or equivalently, it did not increase the overseas money supply aggressively. In turn, the BOK did not need to issue as much in MSBs to absorb excess market liquidity.

### Business and Household Credit

Even though consumption growth has been rising this year, corporate fixed investment has remained relatively weak. In 2005, the uncertainties concerning the prospects for the economic recovery discouraged both corporate investment and demand for money, and banks have concentrated on mortgage lending. The total volume of bank lending to the corporate sector during the period from January through November increased by 16.3 trillion KRW, but household lending was up by 27.3 trillion KRW (Table B.2).

From January through November, lending to large enterprises (LEs), which are flush with cash, increased by 4.2 trillion KRW, and that to small and medium-sized enterprises (SMEs) rose by 12.1 trillion KRW. Banks became somewhat more aggressive in lending to corporations: whereas it had declined by 3.1 trillion KRW in 2004, it began to rise in 2005, suggesting that equipment investment by LEs increased.

Corporate direct financing increased by 7.4 trillion KRW from January through November, up from 6.7 trillion KRW in the same period in 2004. It was led by stock issuance and net issuance of CP and corporate bonds. However, financing through CP and corporate bonds decreased a bit in November, following the increases in interest rates (Table B.3).

Household credit, which includes bank lending to households and merchandise credit from credit card
companies and installment financing companies, rose significantly in 2005. Banks and credit unions were aggressive in their household lending, though there was a slowdown in October and November due to expectations of a downturn in the real estate market. Bank lending to households increased by 1.8 and 2.3 trillion KRW in October and November, respectively (Table B.2).

**Outlook for 2006**

As the economy rebounds in 2006, demand for funds from the private sector should increase. There should also be further inflows of foreign capital for net-buying of Korean equities by foreign investors. The monetary aggregates should all rise at slightly higher rates. The M3 money supply is expected to rise 7.1 percent in 2006, up from 6.2 percent in 2005. We also expect the rate of increase in business credit to accelerate and that of household credit to decline.

**C. Financial Industries**

**C.1 Banking Industry**

**Asset Growth**

The total assets of domestic commercial banks rose 3.4% in the third quarter to 857,269 billion KRW. The total balance of trust accounts increased by 7.3%, after rebounding 0.6% in the second quarter, and the total balance of banking accounts rose by 3.1%.

The total volume of banking accounts rose 3.1% from the previous quarter to 773,907 billion KRW (Figure C.1). In the asset composition of commercial banks, total loans outstanding increased 2.6%. The rise in lending by commercial banks was mainly due to the increase in household lending. Corporate lending continued to be stagnant due to the unfavorable economic conditions. Out of total lending, the proportion of lending to small and medium-sized companies decreased gradually since the second quarter, while that of lending to large companies increased. This is because banks focused more on asset quality than on asset growth. Securities in bank accounts increased 6.5% from the previous quarter.

**Table C.1 Total Assets and Capital of Commercial Banks**

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<tr>
<th></th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1Q</td>
<td>2Q</td>
</tr>
<tr>
<td>Assets in Banking Accounts</td>
<td>718,545 (△0.9)</td>
<td>739,350 (2.9)</td>
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<tr>
<td>Assets in Trust Accounts</td>
<td>83,003 (△4.5)</td>
<td>76,484 (△7.9)</td>
</tr>
<tr>
<td>Total Assets</td>
<td>802,919 (△1.2)</td>
<td>817,841 (1.8)</td>
</tr>
<tr>
<td>Total Stockholder’s Equity</td>
<td>39,078 (10.2)</td>
<td>39,479 (1.0)</td>
</tr>
</tbody>
</table>

Notes: 1) Figures in parentheses represent percentage changes from the previous quarter.  
2) End of period.

Source: Financial Supervisory Service.

Figure C.1 Asset Composition of Commercial Bank
accounts in the third quarter increased 7.3% to 82,536 billion KRW. Much of the increase came in specified money-in-trusts that offer tax benefits and higher yields than bank deposits. Specified money-in-trusts were also used by companies to buy their own stocks.

The total assets of domestic commercial banks are expected to increase. Higher interest rates may cause an inflow of funds to banks, though the volume of the inflow may not be significant because the inflow of funds into non-bank financial institutions is likely to persist as these institutions also offer more attractive yields than banks.

As the economy is expected to recover, the volume of corporate lending is expected to increase, but the growth in total lending may be minimal due to the slowdown in household lending. Since the government set a cap on the loan-to-value ratio for mortgage lending, household lending is likely to decrease.

### Business Performance

Commercial banks' profits for the first three quarters in 2005 were up 68.0% y.o.y. (Table C.2). Non-operating income led the way. Banks were much more conservative in their employment of assets and managed to reduce their bad debt write-offs. Neither net interest nor commissions contributed much to the increase in profits. Net interest margins for the first three quarters in 2005 were lower y.o.y. because the volume of loan rose only slightly as a result of the sluggish economy and the intense competition for deposits (Figure C.3).

Banks offered the special deposit products with high interest rates for a limited time in order to prevent an exodus of funds from bank deposits to alternative investment products. Banks also aggressively increased their mortgage lending, forcing mortgage rates down (Table C.3). In the first three quarters, net interest income increased only 1.2% y.o.y. and commission income decreased 0.4% y.o.y. (Figure C.4). Overall bank profit increased due to the decline in net transfers to set aside reserves for possible loan losses and increases in non-operating income from investment securities.

The total volume of assets in bank trust accounts in the third quarter increased 7.3% to 82,536 billion KRW. Much of the increase came in specified money-in-trusts that offer tax benefits and higher yields than bank deposits. Specified money-in-trusts were also used by companies to buy their own stocks.

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As the economy is expected to recover, the volume of corporate lending is expected to increase, but the growth in total lending may be minimal due to the slowdown in household lending. Since the government set a cap on the loan-to-value ratio for mortgage lending, household lending is likely to decrease.

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more sound as a result of improvement in their capital adequacy and the falling ratio of substandard loans (Figure C.5). The substandard loan ratio declined further in 2005 and reached 1.48% by the end of September, the lowest level since FLC (forward looking criteria) had been instituted to measure bad loans.

At the end of September 2005, the delinquency ratios of small-medium enterprises and households were only 2.2% and 1.4%, and the delinquency ratio on credit card debt decreased sharply from 11.3% in September 2004 to only 3.9% (Figure C.6). The decline in the delinquency ratio was partly a result of the sharp fall in the volume of new bad assets, which in turn was a result of improved credit risk management at banks and the business recovery.

Banks also aggressively moved to reduce their bad loans by selling and writing off bad debts. The BIS ratio, which represents the level of capital adequacy, rose from 11.29% at the end of December 2004 to 12.34% at the end of September 2005 reflecting the high level of retained earnings (Figure C.5). The quality of capital especially improved: BIS tier 1 capital increased from 7.14% at the end of 2004 to 8.71% at the end of September 2005.

**Forecast**

Commercial bank profits are expected to rise in 2006, but not as much as in 2005. Unlike 2005, total profit will be pushed up mainly by stronger operating income, instead of improved non-operating income. In 2006, both interest and non-interest operating income are expected to increase along with the rise in interest rates, increased lending, and reduced loan losses.

Commission income from transfers is also expected to rise on a higher volume of bank transactions. Other forms of commission income will increase as banks increasingly diversify and offer new products such as bancassurance, PB, beneficiary certificates, and pension plans. Non-operating income will not increase sharply in 2006 because the volume of net transfers for loan losses will not be large as a result of the low level of bad loans.
Outlook for 2006

The total assets of commercial banks are expected to increase due to the rising interest rates, but the growth may be minimal because the inflow of funds into the stock market is likely to persist due to the rising stock prices. As the economic recovery gains strength, corporate lending is expected to rise.

The soundness and capital adequacy of the commercial banks in 2006 are expected to continue improving. The delinquency ratio will naturally fall further as personal incomes rise, and the rate of late payments for unsecured loan will stay low. Nevertheless, there is some need for caution in handling mortgage loans because higher interest rates will increase the interest burden on mortgage borrowers, and the decline in housing prices may cause some mortgage borrowers to become insolvent.

The quality of capital adequacy will improve: the BIS tier 1 ratio will rise because of the enormous volume of earnings retained in 2005.

C.2 Non-Banking Financial Institutions

Credit Card Companies

In the third quarter of 2005, the total assets of the six largest credit card companies rose to 27.4 trillion KRW (Figure C.7) from 26.9 trillion KRW in the previous quarter. However, card assets, as a whole continued to fall since 2003 because cash advance services had been incrementally reduced. For that reason, the portion of card assets out of total assets decreased to 39.8% from 41.6% in the previous quarter. Lease assets rose to 0.9 trillion KRW because of the expansion of leasing operations for automobiles. Installment assets rose 10.4% to 1.9 trillion KRW, reflecting higher consumer confidence.

All credit card companies reported positive net income for the second and third quarters of 2005, and total net income was reported at 522.1 billion KRW in the third quarter (Figure C.7). LG Card, the largest credit card company, reported net profit of 363.4 billion KRW. Samsung Card and Hyundai Card reported net profits of 63.7 billion KRW and 31.9 billion KRW.

The delinquency ratio on all at the six companies debt declined to 11.9% in the third quarter from
Credit card companies are expected to step up their marketing efforts in 2006, and total assets and net income should rise in the coming quarters. Each of the credit card companies can be expected to compete for greater market share.

Credit Finance Companies other than Credit Card Companies

The total assets of leasing companies, installment finance companies, and venture capital companies increased by 3.7%, 4.7%, and 20.7%, respectively in the third quarter (Table C.5). Their total installment assets rose from 3.7 trillion KRW to 4.1 trillion KRW (Figure C.6). However, the government’s new policy against real estate speculation served to discourage demand for house installment finance.

Total lease assets have risen at an average quarterly rate of 5.5% since 2004. As the automobile lease market rapidly expanded, large installment finance companies expanded their automobile leasing operations. This was the main reason for the sharp increase in lease assets at credit finance companies. Venture capital assets continued to decrease since the venture capital bubble began to deflate, but not as rapidly as in the second quarter.

Installment finance companies reported high total combined net income of almost 572 billion KRW in the third quarter. The increase was mainly a result of a lower burden of bad debt expenses and an increase in interest income (Table C.6). Leasing companies recorded net income of 155 billion KRW, benefiting from the sharp increase in leasing of automobiles.

Venture capital companies showed positive quarterly net income as a result of profits from factoring and investment returns. Credit quality and the capital adequacy of credit finance companies were maintained at high levels. The loan loss reserves and
substandard loan ratio of installment finance companies had improved since the second half of 2004.

Installment and lease assets may continue to rise as private consumption is expected to recover. However, the lease market will become more competitive because the large installment finance companies, credit card companies, and foreign leasing companies are expected to expand their leasing operations.

**Mutual Savings Banks**

Total assets at MSBs increased 1.3% to 38.9 trillion KRW in the third quarter, but their total deposits fell 1.1% to 34.7 trillion KRW because the deposit rate spread between MSBs and commercial banks narrowed (Figure C.7). The volume of micro credits continued to decrease, and project financing increased at a slower rate. The total volume of loans outstanding in the third quarter rose only 2.9%, in large part due to competition with other financial institutions and the government's effort to discourage real estate speculation.

The performance of MSBs improved greatly in the third quarter of 2005 compared to the previous periods (Table C.7). The total net income of MSBs rose to 175.2 billion KRW, the highest level since the financial crisis. This earnings surprise was the result of a strong gains on securities investments and project financing services.

Non-operating profit, mainly from sales of office buildings, also contributed to the sharp increase in net income. The BIS capital adequacy ratio rose 1.54%p from the end of FY2004 to the first quarter of FY2005. The delinquency ratio and substandard loan ratio improved modestly to 21.30% and 13.10% from 22.37% and 15.35% over the same period.

The Financial Supervisory Committee is expected to lighten some restrictions for MSBs that meet certain soundness criteria in the near future. The profitability of MSBs is expected to improve as a result, but weak MSBs will fall even further behind their healthier competitors. The volume of loans to the construction industry may decrease as a result of the government's efforts to cool down the overheated real estate market.
Table C.7 Financial Indicators of MSBs
(Units: Bil. KRW, %)

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<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>82.2</td>
<td>-62.7</td>
<td>-136.2</td>
<td>-195.7</td>
<td>175.2</td>
</tr>
<tr>
<td>BIS capital ratio</td>
<td>8.74</td>
<td>8.18</td>
<td>7.01</td>
<td>7.13</td>
<td>8.67</td>
</tr>
<tr>
<td>Delinquency ratio</td>
<td>20.94</td>
<td>21.15</td>
<td>22.81</td>
<td>22.37</td>
<td>21.30</td>
</tr>
<tr>
<td>Substandard &amp; below loans Ratio</td>
<td>11.75</td>
<td>12.37</td>
<td>13.02</td>
<td>15.35</td>
<td>13.10</td>
</tr>
</tbody>
</table>

Note: Net income is calculated biannually (but, data in September 2005 is quarterly).
Source: Financial Supervisory Service.

Table C.8 Total Assets & Ratio of Credits to Deposits at Mutual Credits
(Units: Tril. KRW, %)

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>3Q</td>
<td>4Q</td>
</tr>
<tr>
<td>Total Assets</td>
<td>172.9</td>
<td>183.9</td>
</tr>
<tr>
<td>Credits</td>
<td>109.8</td>
<td>111.5</td>
</tr>
<tr>
<td>Deposits</td>
<td>137.9</td>
<td>141.3</td>
</tr>
<tr>
<td>Ratio of Credits to Deposits</td>
<td>68.7</td>
<td>69.1</td>
</tr>
</tbody>
</table>

Source: Financial Supervisory Service.

Table C.9 Financial Indicators of Mutual Credits
(Units: Bil. KRW, %)

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>4Q</td>
<td>1Q</td>
</tr>
<tr>
<td>Net income</td>
<td>13.8</td>
<td>16.1</td>
</tr>
<tr>
<td>Agricultural</td>
<td>-995.8</td>
<td>1.2533</td>
</tr>
<tr>
<td>Fisheries</td>
<td>43.3</td>
<td>-12.9</td>
</tr>
<tr>
<td>Forestry</td>
<td>2.6</td>
<td>-0.5</td>
</tr>
<tr>
<td>Delinquency ratio</td>
<td>15.7</td>
<td>18.4</td>
</tr>
<tr>
<td>Agricultural</td>
<td>5.7</td>
<td>6.8</td>
</tr>
<tr>
<td>Fisheries</td>
<td>10.1</td>
<td>11.2</td>
</tr>
<tr>
<td>Forestry</td>
<td>8.9</td>
<td>10.0</td>
</tr>
<tr>
<td>Loan-loss reserve ratio</td>
<td>6.0</td>
<td>6.5</td>
</tr>
<tr>
<td>Agricultural</td>
<td>2.4</td>
<td>2.7</td>
</tr>
<tr>
<td>Fisheries</td>
<td>4.3</td>
<td>4.9</td>
</tr>
<tr>
<td>Forestry</td>
<td>3.3</td>
<td>3.7</td>
</tr>
<tr>
<td>Net capital ratio</td>
<td>107.9</td>
<td>104.1</td>
</tr>
<tr>
<td>Agricultural</td>
<td>196.3</td>
<td>175.2</td>
</tr>
<tr>
<td>Fisheries</td>
<td>113.1</td>
<td>109.2</td>
</tr>
<tr>
<td>Forestry</td>
<td>129.3</td>
<td>115.1</td>
</tr>
</tbody>
</table>

Notes: 1) Loan-loss reserve ratio is the ratio of reserved allowances for the credit losses of mutual credits relative to the minimum required allowances for the credit losses.
2) Net income is calculated quarterly.
Source: Financial Supervisory Service.

Mutual Credits

The total assets of mutual credits (agricultural cooperatives (ACs), fisheries cooperatives (FICs), forestry cooperatives (FOCs) and credit unions (CUs)), in the third quarter increased by 1.9% to 194 trillion KRW (Table C.8). Total deposits rose to 150.2 trillion KRW. The tax exemptions on interest income and higher interest rates made mutual credits more attractive to depositors compared to other depository institutions. Total credits rose 1.9% to 119.8 trillion KRW in the third quarter of 2005, driven by increased lending collateralized by real estate. The ratio of credits to deposits increased slightly to 70.7% from 70.1% in the previous quarter.

All mutual credits reported positive net income for the second and third quarters of 2005 (Table C.9) as a result of restructuring of FICs and CUs.

ACs, the largest mutual credits, showed solid credit quality and capital adequacy, but the soundness indicators of CUs were still weak. The net capital ratio of ACs and FCs were maintained at good levels or 6.42% and 10.24%. FICs, on the other hand, still suffered impairment of capital despite deep restructuring.

ACs will continue to show steady growth. The profitability and soundness of FICs and CUs are expected to improve as restructuring proceeds further.

C.3 Securities Industry

Assets

In 2005, the total assets of securities companies rose substantially relative to other major financial institutions. During the first half of 2005, the assets of banks and insurance companies rose 4.5% to 750.5 trillion KRW and 3.4% to 217.1 trillion KRW respectively. The securities companies experienced a huge increase in total assets of 23.9% to 64.9 trillion KRW in the same period because investors were attracted by the steep run-up in stock prices instead of putting their money in banks or insurance companies (Figure 11).
Profitability

During the first half of FY 2005 (from April 1 to September 30), securities companies realized a total gain of 1,544.2 billion KRW in pre-tax income, nearly three times the 595.5 billion KRW reported in the first half of FY 2004. Most of the increase was due to the higher volume of brokerage commissions earned during the boom in the stock market. The brokerage commissions of the KOSPI and KOSDAQ markets increased 33.2% to 349 trillion KRW and by 155.8% to 197 trillion KRW respectively compared with the previous year. The earnings from brokerage commissions at securities companies increased by 37.6% to 2,075.6 billion KRW.

Securities companies also participated in the OTC financial derivatives market. The volume of ELS issues increased 122.6% to 6.9 trillion KRW in the first half of FY 2005 from 3.1 trillion KRW in the same period of 2004. As a result, the commissions from ESL soared 191.4% to 155.9 billion KRW in the first half of FY 2005 from 53.5 billion KRW in the previous year. Securities companies also succeeded in improving their earnings and expense structures. They managed to reduce costs because the restructuring of convertible securities companies had been completed.

Capital Adequacy and Liquidity

The net capital ratio (an indicator of the capital adequacy of securities companies) of domestic securities companies rose 164% from 403.9% at the end of 2004 to 567.9% at the end of June 2005. This was largely a result of a 2,101.6 billion KRW increase in net capital. It was also partly brought about by a decrease in total risk capital of 218.3 billion KRW: securities companies increased the portion of deposits and call loans rather than high risk assets. The net current asset ratio of securities companies fell slightly from 13.2% at the end of 2004 to 12.5% by the end of June 2005. This is still a healthy level, but is well below the figure for foreign securities companies: 37.1%.

Outlook for 2006

The domestic securities companies will continue to
increase their total assets as the domestic stock market is expected to remain in an uptrend in 2006. Individual investors will continue to prefer indirect investments; pension funds will invest more heavily in the stock market; and the retirement pension schemes will go into effect in December 2005. It is also expected that new integrated capital market act will lead to the deregulation of the securities industry. The securities companies will focus more on the businesses of the investment banks such as M&As, corporate finance, and investment advisory. In so doing, they will need to increase their equity capital through M&As to be more competitive and prepared for high risks.

In 2006, the securities companies are expected to report roughly the same level of profits as in 2005. Because individual investors prefer indirect investment in the stock market, the turnover ratio of stock trading will fall, which may reduce the revenue from brokerage commissions. In spite of these factors, the securities industry should see good profits in 2006 because of the upward trend in the stock market.

C.4 Insurance Industry

Life Insurance

The total assets and premium income of the life insurance industry in FY2005 have been rising at a relatively strong rate despite the slow economy. Premium income is estimated to rise 8.4% over the previous year to 58,282 billion KRW (Table C.15), mainly due to a rise in sales of investment-type insurance such as variable life insurance (encouraged by the on-going rally in stock prices) and group insurance. Total assets are estimated to rise 13.5% to 240,177 billion KRW (Table C.15). However, the enforcement of the new regulations including the regulation concerning amortization of deferred acquisition expenses may serve to reduce the life insurers' underwriting profits.

The investment profits of the life insurance industry in FY2005 are estimated at 11,511 billion KRW, fueled by rising stock prices (Figure C.15). Life insurance companies have remained conservative in their investment, though they have increased the proportion of stocks to some degree in their investment portfolios.
As one special feature of the life insurance industry, foreign insurance companies have been carving out larger market shares thanks to their aggressive and efficient distribution strategies. They have been employing highly qualified solicitors and exploiting new channels such as bancassurance and home shopping networks very aggressively.

The average solvency margin ratio of the life insurers as of June 2005 was above 200, a reasonable level (Figure C.17). However, the FSS (Financial Supervisory Services) authority started to enforce more stringent solvency margin standards, so the actual solvency margin ratio in FY2005 is likely to fall somewhat.

Non-Life Insurance

The non-life insurance industry in FY2005 has continued to grow even despite the failure of the economy to rebound more strongly. Premiums written are expected to rise 8.5% over the previous year to 24,443 billion KRW, and the total assets are expected to increase 12.5% to 48,765 billion KRW (Table C.13). Steady and strong growth in sales of long-term insurance such as super personal insurance and long-term care insurance is leading the growth of the entire non-life insurance industry.

Generally, long-term insurance generates more stable streams of premium income than any other type of non-life insurance over the long term. The growth in sales of long-term insurance has been encouraged by increased interest in long-term health care and other health-related types of insurance due to the rapid aging of society.

The auto insurance industry is not performing as well because of overheated price competition and a rising loss ratio. Only the online auto insurers are doing well as they can offer auto insurance at rates that are 15~20% lower than offline auto insurers, and they are gaining a larger market share.

Non-life insurance companies have performed well in the investment business, benefiting from the rally in the stock market (Figure C.18). Especially, non-life insurers are making investment profits on sales of short-term securities as well as profits on derivatives invested and interest income.

While the actual solvency margin ratios of non-life
insurance companies are also at reasonable levels, they are likely to decline somewhat if the new solvency margin standards are applied (Figure C.20). Those small & medium-sized non-life insurance companies that have low solvency margin ratios will need to raise capital to meet the more stringent solvency margin standards.

**Outlook for 2006**

The total assets and premium income of the life insurance industry are expected to rise at a higher rate in 2006, driven mainly by new demand stemming from the implementation of the retirement pension system, greater demand for some types of insurance such as variable life insurance and health-related insurance, as well as by the expectations of an economy recovery. Sales of variable life insurance, which is a hybrid of a pure insurance and investment instruments (also deposit feature for variable universal life policies), are forecast to rise strongly and steadily through 2006.

The rally in stocks should make this type of insurance very attractive to those customers who cannot find good investments as a result of the low interest rates and new, more stringent regulations on real estate investment (the so-called, 'August 31 real estate regulations'). In addition, the fact that life insurers will be permitted to offer some types of non-life insurance (products that compensate for actual losses) should benefit the growth of the life insurance industry.

Life insurers are expected to increase the proportion of stocks in their investment portfolios somewhat, though they will maintain a conservative stance in their investment. Foreign life insurers will continue to employ aggressive and efficient distribution strategies and can be expected to claim even larger shares of the domestic life insurance market.

As in 2005, the non-life insurance industry is expected to continue to grow. Its growth will be fueled mainly by expectation of a stronger economic recovery, further increases in stock prices, and a steady rise in sales of long-term non-life insurance. In the underwriting business, long-term non-life insurance will continue to drive the growth of the entire industry, while the automobile insurance industry will likely slowdown further because of the
heated price competition, rising traffic accident rate, and increasing insurance fraud.

The high growth of long-term non-life insurance will be driven by greater demand for savings-type insurance, health and long-term care insurance, and by the offering of a wider range of new products such as super personal insurance and critical illness insurance. The online auto insurers should continue to claim greater market share, but the automobile insurance market overall is likely to be weak for some time.

The non-life insurers will likely be more aggressive in their asset management (e.g., increasing the proportion of stocks in their investment portfolios) as the current rally in stocks is forecast to continue in 2006.

The implementation of the retirement pension system will have less impact on the non-life insurance industry than on the life insurance industry, and the new regulation permitting life insurers to handle some non-life insurance types of products will serve to reduce the premium income of non-life insurers in the long run.

Further deregulation in the insurance industry such as removing walls between life and non-life insurers is expected to occur in 2006. The deregulation is intended to promote the growth of the entire insurance industry so that it can serve as an effective social safety net, which is an urgent undertaking in light of the rapid aging of society.

In 2006, the supervisory authority is expected to take stronger countermeasures against insurance fraud. Fraud accounts for an estimated 10% of total claims paid and shows every indication of increasing. It not only compromises the financial soundness of insurers but forces up premiums for all insureds. Clearly, the supervisory authority and insurers should work closely together to counter it.

The social safety net is still very inadequate in light of the very rapid aging of Korean society. Korea is aging more rapidly than nearly every other developed country (Table C.15). As one of countermeasures against this problem, the government is preparing to introduce a government-guaranteed reverse mortgage system. Reverse mortgages are specialized loans that enable seniors to tap their home equity while they...
Table C.15 Comparison of Aging Speed (OECD countries)

<table>
<thead>
<tr>
<th></th>
<th>Aging Society → Aged Society</th>
<th>Aged Society → Super-Aged Society</th>
</tr>
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<tbody>
<tr>
<td>France</td>
<td>115 years</td>
<td>40 years</td>
</tr>
<tr>
<td>USA</td>
<td>72 years</td>
<td>16 years</td>
</tr>
<tr>
<td>UK</td>
<td>47 years</td>
<td>44 years</td>
</tr>
<tr>
<td>Japan</td>
<td>24 years</td>
<td>12 years</td>
</tr>
<tr>
<td>Korea</td>
<td>18 years</td>
<td>8 years</td>
</tr>
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Reverse mortgages are considered a very effective way to utilize assets in an aging society, and they should reduce the budget strains on the government due to welfare spending for the elderly.

Because there are limits to the effectiveness of the current EU-based solvency supervision system, the FSS announced a new initiative to establish a risk-based supervisory framework that focuses on prevention of problems before they materialize. The new supervisory system will help to reinforce the foundation of insurance companies and the entire financial system.
A. Universal Banking in Korea

[Sangho, Sohn, Ph.D., Tel. 02-3705-6358, shsohne@kif.re.kr]

1. Universal Banking in Korea

From the perspective of balanced growth in the financial sector and permitting the mutual entry of each financial institution, universal banking has recently emerged as a key issue in Korea. Adopting adequate financial policies would promote the rapid growth and development of the financial sector and do much to ensure balanced growth among sectors. During the restructuring process started in the aftermath of 1997 financial crisis, however, the shift of vast assets from non-banking financial institutions into banks raised uncertainties about the future prospects of non-banking institutions.

In response to the competitive threat from banks, non-banking financial institutions (including brokerage and insurance companies) strived to develop new financial products and services and called for the removal of the restrictions on financial institutions against entering the core businesses of other types of financial institutions, especially those of banks. As a result, the debate narrowed down to two critical issues: the separation of banking and commerce, and permitting non-banking financial institutions to offer payment and settlement services. Securities companies called for permission to handle payments and settlements through their CMAs and argued that this in-house service would improve their profitability as well as financial consumers' welfare. They declare that these new businesses will allow them to increase profits. It is also true that their entry into new businesses would lead to lower service fees and improved service quality by promoting competition between financial institutions.

2. Merits and Demerits of Universal Banking

There are both merits and demerits to allowing new financial activities to certain financial institutions. The merits of the universal banking system include the economies of scale and scope; reduction in operating costs, greater consumer welfare in the form of one-stop service, lower financial risk due to diversification, and greater competition among financial institutions. The demerits of universal banking are the greater risk of monopoly or oligopoly and increased concentration of market power in the financial sector, greater possibility of conflicts of interest between financial institutions, reduced competitiveness of the financial industry due to loss by each institution of its competitive edge, greater financial system instability, and greater difficulty in conducting prudent financial supervision. Since there are trade-offs between the merits and demerits of universal banking, an optimal solution must be found that allows for both financial industry development and improved consumer welfare. Furthermore, proper strategies such as establishing strategic alliances, subsidiaries, and financial holding companies must be implemented in a timely way, and each financial institution must devise its own strategies for universal banking.
3. Possibilities and Limitations of Mutual Integration in Financial Sector

Financial institutions have not been permitted to engage in businesses that have traditionally been the domain of other types of financial institutions. Payments and settlements, and deposits and loans were the core businesses of commercial banks because they are characterized by low-risk and low-profitability and such businesses require greater safety and stability than other financial businesses. The main risk factors of securities companies, which seek high risk and high returns, are in the potential losses from market activities. The core businesses of insurance companies, which on occasion incur unexpectedly large losses, rely on statistical methods based on the law of large numbers.

Even though every financial institution is basically profit seeking, each has a different risk profile depending on the stability, profitability, and term-structure of its core businesses. Banks are required to maintain safety and stability because core businesses of banks as payment and settlement, and deposit and loan services are essential to the economic system of a country. In the case of securities firms, positive risk-taking, rather than safety and stability, is recognized as the main characteristic of the business since their profits are mainly from brokerage activities. Insurance companies focus on managing the risk of many, unspecified persons since their core business is based on the law of large numbers.

Mutual entry into the core businesses of other types of financial institutions would likely have significant ramifications for financial soundness, sustainable growth, and the moral hazard problem. If banks are permitted to enter into the core business of either securities firms or insurance companies, and vice versa, there may be greater systemic instability and moral hazard resulting from cross-subsidies as well as slower growth of the financial industry. This is also applicable to the other combinations of the mutual entries of financial institutions. Particularly, if either securities firms or insurance companies are permitted to enter the core business of banks, the financial authorities would have to focus supervision on commercial banks' activities, and this would hinder the development of either securities firms or insurance companies.

4. Basic Orientation of Universal Banking in Korea

The number of core businesses of each sector in the financial industry should be reduced to the minimal, and financial institutions should be permitted to engage in as many non-core subsidiary financial businesses as possible. The regulatory and supervisory bodies need to adopt a negative list system in defining financial products rather than the current positive list system. (The negative list system of financial regulation means that market players are allowed to do everything unless otherwise prohibited by law.) This requires that we list and clarify the core businesses of a financial institution and then reestablish the concepts of subsidiary financial activities and in-house financial activities of the institution according to the concept of the core business.
B. Profit Sustainability of Korean Banks

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1. Overview of Korean Banks’ Profitability

Korean banks’ profits in the first three quarters of 2005 soared 85.3% to 10 trillion, 521 billion Korean won compared with the corresponding period of last year. The net income of Korean banks in the first three quarters of 2004 was 5 trillion, 679 billion won. This sharp increase was mostly due to reductions in provisions for allowances, increased revenues on securities, declines in non-performing corporate and household loans, and improved bank performance after restructuring. Even with the ongoing recession and low interest rates, Korean banks posted their highest net profits ever by focusing on the management of assets. Korean banks' average ROA is now 1.32%, which is close to the ROAs of banks in developed countries. In 2004, the ROA of Korean banks was 0.9%, which compares with the average ROA of the US banks of 1.31% and the average ROA of the five largest British banks (1.25%).

It must be noted, however, that gross income, the measure of a bank's ordinary operating performance, fell 1.6% from the corresponding period of last year. Income before provisions, the measure of a bank's ability to generate income, rose only 7.3% from the same period. These figures indicate that the operating performance of Korean banks and their ability to generate income have deteriorated.

2. Income Structure of Korean Banks

Figure 1 shows the composition of Korean commercial banks' gross income over the period from 2001 through the first three quarters of 2005.

Korean banks' net interest income was 20.5 trillion won for the first three quarters of this year. This was higher than their net interest income of 20.2 trillion won for the corresponding period of last year (19.7 trillion won). However, the growth in structural income, which includes net interest income, has been declining since 2001. Low interest rates naturally have negative influence on Korean banks' net interest income, and the slowdown in corporate lending due to slack corporate investment has slowed the growth of banks' assets. Considering that corporate lending is more profitable than household lending, the fall-off in the former has negatively impacted banks' profitability. On the other hand, the maintenance of a certain interest rate spread and the resolution of bad credit card debt will ensure continued growth in net interest income. The net interest margin has been decreasing since 2001 for Korean commercial banks because of the low lending interest rates and slowdown in the growth of bank assets.
Korean banks' non-interest income for the first three quarters of 2005 was 3.2 trillion Korean won, a decline of 6.7% from the corresponding period of last year (4.4 trillion Korean won). Non-interest income has accounted for 13.5% of gross income this year, which is much lower than 18.2% last year. Korean banks have been working hard to diversify their income streams because of the lower profitability of deposits owing to the low deposit interest rates and the saturation of the lending market, but much remains to be done. Most of the decline in non-interest income was in fees & commissions received and revenues on securities, and non-interest income accounted for only 13.5% of gross income in the first three quarters of 2005. Fees & commissions received accounted for 10.7%. At US banks, commissions on the sales of financial products are about 27% of gross income. Figure 2 compares Korean banks' income sources with those of US banks.

The Korean banks' outstanding performance was largely a result of their focus on risk management and restraining themselves from employing unprofitable strategies, which is a desirable development. Korean banks' ROAs are 1.32% on average, which is close to the ROAs of banks in developed countries. However, considering the fact that Korean banks' ROAs are still lower than those of IBP banks, we need to consider these figures from a proper perspective.

3. Factors of Profit Unsustainability of Korean Banks

Korean banks reported net income of 10.5 trillion won for the first three quarters of this year, but this increase was mostly due to non-recurring factors such as non-operating income rather than banks' own ability to generate income. The increase in non-operating income was mainly due to revenues on securities and fees & commissions received. Non-recurring income was pushed up significantly by the resolution of bad assets through restructuring of insolvent financial institutions. Net interest income and income before provisions, appropriate measures for banks' operating performance, decreased over the first three quarters of 2005 compared with the corresponding period of 2004. Non-recurring factors accounted for 21.8% of net income in the first half of 2005, as compared to less than 10% in the first half of 2004. It is clear that banks cannot expect to sustain their profitability at current levels in the future without serious action.

4. Strategies to Improve Profit Sustainability of Korean Banks

Banks must diversify their income streams. For this purpose, they should establish a system that enables them to concentrate their efforts and resources on core customers. Retail banking has
become very important for profitability, and to improve retail profits, banks must be able to adapt quickly to change in the business environment based on deep understanding of customers' needs. Banks must also desist from quantitative growth and focus on profitability. Another difficulty toward increasing profits is conflicts of interest between new business operations and existing operations.

C. Amendment of the Financial Industry Restructuring Act

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1. Core Issues

The Financial Industry Restructuring Act of Korea (FIRA, henceforth) has been in effect since March 1997, and is in the process of amendment. The core issue of the amendment is whether the financial supervisory authorities may retroactively enforce regulation against a financial institution or affiliated financial institution that possesses or maintains holdings of another company's stock over the limit set forth in the FIRA (esp. Article 24), which also addresses ex-post approval, voting right restrictions, and disposal of the stock etc. The government and opposition parties are at odds over this issue, but there are few reasons to override the regulations.

2. Assessment

First, the regulation does not violate the principle of the non-retroactive effect of the law, which is applicable to an act or legal relationship completed in the past. Excessive stockholdings persist to the present time. Second, many opponents argue that the retroactive regulation may infringe upon individual property rights, respect for the law, etc. However, these problems can be avoided or minimized if the financial supervisory authorities examine illegal stockholdings and apply the regulation based on a general principle of clarity, severity, proportion, and complement.

Clarity means that the illegal condition can be well-defined and understood: Article 24 of the FIRA is clear in that it defines the illegal condition as "owning more than 20% of another company's stock", or "owning more than 5% and exercising control over the company". "Severity" means that the illegal condition harms competitors or consumers by compromising the market mechanism; hence, the retroactive regulation might be rationalized if the harm to competitors or consumers is more serious than the infringement on individual property rights. "Proportion" means that the degree of regulation should be in proportion to that of the severity of the illegal condition; i.e., the detrimental effect of the condition. Lastly, "complement" means that there should not exist any alternative or substitute measure except voting right restrictions or disposal of the stock etc. in order to eliminate or minimize the influence of the illegal condition. The FIRA has some defects, however. First, its intention and design are inconsistent; the aim of the FIRA is to maintain the efficiency and fairness of the financial market (Chapter 1), but it also addresses other issues such as mergers, conversions, liquidations, and bankruptcies of financial institutions. Second, the FIRA and other laws overlap in many respects: its 2nd and 5th chapters are closely related with the Monopoly Regulation and Fair Trade Act (MRFTA); its 3rd chapter is in a sense a subset of the financial supervisory regulation; and its 4th chapter is
very similar to the corporate act or bankruptcy act. The intention of the 5th chapter (i.e., Article 24) is to maintain the efficiency, fairness, and stability of the financial and real sector, which is beyond the purview of the FIRA.

3. Concluding Remarks

Apart from the on-going amendment of the FIRA, it needs to be fully reviewed and revised in the near future: its 2nd, 3rd, and 4th chapters should be transferred to the MRFTA, the financial supervisory regulation, and the bankruptcy act (or corporate act) respectively. Article 24, the remainder of the FIRA, should be included in a regulation that separates affiliated financial institutions from affiliated industrial companies, vertically or horizontally. This regulation will help maintain and improve the efficiency, fairness, and stability of the financial and real sector in Korea by preventing unfair support or unhealthy control relationships among the affiliated companies. It is also one of seven measures that the Korean government has promoted to eradicate the vicious cycle of control between financial institutions and industrial companies in large Korean conglomerates.

D. The Population Aging Problem

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1. Introduction

The steep decline in fertility and increasing life expectancy is causing Korean society to age faster than any other OECD country. Korea officially became an "aging society" in 2000, when the aging index (the percentage of the population aged over 65) reached 7.2%. Korea is predicted to become an "aged society" by 2019, by which time the percentage of the population aged over 65 will exceed 14%. According to OECD data, Korea will likely move from the aging society stage to the aged society stage more rapidly than any other country in history. Korea will see a very high dependency ratio (ratio of people aged over 65 to the number of people aged 20–64) in the near future.

Table A. Rates of Population Aging

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<tr>
<th>Country</th>
<th>Aging Index</th>
<th>7% (Aging Society)</th>
<th>14% (Aged Society)</th>
<th>20% (Super Aged Society)</th>
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<tr>
<td>France</td>
<td>1984</td>
<td>1979</td>
<td>2019</td>
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<tr>
<td>Norway</td>
<td>1985</td>
<td>1977</td>
<td>2021</td>
<td>92</td>
<td>44</td>
<td>14%</td>
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<tr>
<td>Sweden</td>
<td>1987</td>
<td>1972</td>
<td>2011</td>
<td>85</td>
<td>39</td>
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<tr>
<td>Australia</td>
<td>1939</td>
<td>2012</td>
<td>2030</td>
<td>73</td>
<td>18</td>
<td>14%</td>
</tr>
<tr>
<td>USA</td>
<td>1942</td>
<td>2014</td>
<td>2030</td>
<td>72</td>
<td>16</td>
<td>14%</td>
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<tr>
<td>Canada</td>
<td>1945</td>
<td>2010</td>
<td>2024</td>
<td>65</td>
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<tr>
<td>Italy</td>
<td>1927</td>
<td>1988</td>
<td>2008</td>
<td>61</td>
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<td>UK</td>
<td>1929</td>
<td>1976</td>
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<tr>
<td>Germany</td>
<td>1932</td>
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<td>2010</td>
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<tr>
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<td>1994</td>
<td>2006</td>
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<td>Korea</td>
<td>2000</td>
<td>2018</td>
<td>2026</td>
<td>18</td>
<td>8</td>
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</table>
Korea does not yet seem to be well prepared for this challenge. While Korea is experiencing very rapid aging compared to nearly every other developed country, the social safety net for senior citizens is still very inadequate. Many Koreans are seriously concerned about their livelihoods after retirement. To address this problem, the retirement pension system and reverse mortgage system need to be fully established.

2. Establishment of Retirement Pension System

The Retirement Pension Scheme (RPS) pays retirees what their companies have saved for them in financial institutions, in the form of either lump sum benefits or annuities. The Retirement Allowance Scheme (RAS) has become less active due to the reduced application of progressive rates to older workers, wider use of the annual salary system, and the increasing job changing rate. The RAS also does not guarantee a secured payment to the retirees when companies go bankrupt because most companies hold large portions of retirement funds in-house. Neither does the RAS offer portability when employees change jobs. The Employee Retirement Income Security Act (ERISA) was put into effect in December 2005 to solve these fundamental problems, and it introduced the RPS.

There are some problems with the ERISA that need to be pointed out, however. First of all, the RPS is not mandatory. Employers and employees may choose between the RAS and RPS by mutual consent. Therefore, there is little incentive in the ERISA for employers and employees to switch to the RPS from the RAS. Second, when companies or financial institutions become bankrupt, the RPS does not fully guarantee secure payments to the retirees. Third, the Korean RPS does not have a good governance structure such as the US, where several parties including trustees, fund administrators, external audits, and deposit accountants check and monitor one another in the scheme. Lastly, OECD countries, such as Japan and the US, do not regulate the management of pension assets for Defined Contributions (DC). The ERISA actually prohibits companies' direct investment in stocks, and indirect investment for DC cannot exceed 40%.

The following measures need to be taken if the RPS is to be fully institutionalized as soon as possible. First, the government should provide sufficient tax incentives both to employers and to employees. Second, systems and laws should formulated and revised to protect the trustees against bankruptcy of companies or financial institutions. Third, the governance structure of the RPS must be improved. Lastly, to afford a variety of choices to the employers and the employees, restrictions on fund management should be eased, unless it hinders the secure payment of retirement pension benefits.

3. Introducing the Reverse Mortgage System

The Korean government is currently preparing to introduce the reverse mortgage system. Reverse mortgages are specialized loans that enable seniors to tap their home equity while they continue to live in their homes and are considered a very effective way to utilize assets in an aging society. The system has become popular in the US since 1989 and in some other developed countries such as the UK and Japan.

To successfully introduce the reverse mortgage system, the experiences of other developed countries need to be considered. First of all, like the HECM (Housing Equity Conversion
Mortgage) in the US, the reverse mortgage system must be government-insured. For the HECM, the FHA (Federal Housing Administration) protects lenders (financial institutions) from potential risks such as crossover risk and interest rate risk, which the lenders might otherwise face in their handling of HECMs. In addition, the FHA insures borrowers in case lenders become bankrupt and are unable to provide the payments promised to borrowers. Second, various benefits such as tax benefits should be provided to borrowers in order to enable seniors to receive more monthly payments given the appraised values of their homes. For example, in the US, the reverse mortgage payments seniors receive are tax exempt. And, the interest expenses paid or accrued for a reverse mortgage may be tax deductible because a reverse mortgage is regarded as a form of 'home equity indebtedness'. In addition to tax benefits, exempting or reducing costs such as origination fees, closing costs, etc, levied on borrowers should be considered. Third, promotional campaigns should be staged to raise awareness of reverse mortgages. This is absolutely essential, and these campaigns must address the attitudinal factors affecting elderly homeowners' decisions. Furthermore, like the HECM, counseling should be offered to seniors before applying for reverse mortgages to ensure that they make truly informed and prudent decisions.

E. Economic Recovery of Japan and the Yen/Dollar Rate

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The Japanese economy is now widely acknowledged as having finally emerged from its extraordinarily long recession. This assertion is supported by economic data such as GDP releases and retail sales, to name a few. After turning positive in the fourth quarter of 2004, growth in GDP managed to remain positive for three consecutive quarters in 2005. Retail sales have also increased steadily, indicating that the recovery is also being driven by strong domestic demand.

The economic conditions of Japan suggest that the yen/dollar exchange rate should fall (i.e. the yen should strengthen). In 2005, however, the yen actually weakened throughout most of the year despite signs of recovery. The major reason for this was the widening interest rate differential between the US and Japan due to consecutive interest hikes by the Fed. This has caused many to question whether the yen would strengthen soon since the Fed is expected to be less hawkish in the near future.

Correlation analysis of various economic indicators and the yen/dollar exchange rate shows that both industrial production and the Tankan Index (business conditions index) move closely with the yen/dollar with a two-year lag. That is, both indexes lead the yen/dollar rate by about two years (see figures A and B).
As we can see in Figures A and B, the correlation between the two indexes and the yen/dollar exchange rate is fairly high with a two-year lag. This means that the yen appreciates when the economy is booming, but after roughly two years, it starts to depreciate. This interesting phenomenon can be explained by the equity purchases of foreign investors. Foreign investment increases and then begins to decline after some time. This decline can be interpreted as a sign of disappointment in the Japanese economy, which was initially believed to be entering a possible recovery.

Interestingly, none of the financial indicators show high correlation with the yen/dollar exchange rate, except the 10-year interest rate differential, rate of increase in M2, and foreign investors’ purchases of stocks.

Regression analysis of the yen/dollar and various economic indicators shows that the industrial production index is significantly correlated with the yen/dollar exchange rate. However, this strong correlation has weakened since 2002, and this has lead to speculation that there has been some kind of structural change these past three years.

The most important development is the 'reform drive' initiated by Prime Minister Koizumi since his administration came into power in April of 2001. His reform policies are generally designed to reduce the chronic fiscal deficit, resolve bad loans in the banking sector, and deregulate and privatize government enterprises.

Reduction of non-essential government expenditures, introduction of an issuance limit of 30 trillion yen on government bonds, and cuts in medical expenses brought the fiscal deficit down to 6% in 2004 compared with 8% in the late 90's.

The banking sector has also experienced some changes as well. After going through some restructuring and evaluation of the bad loans of the financial sector as well as debt securitization through the Industrial Bank of Japan, the volume of NPLs (non-performing loans) since 2002 has fallen significantly.

Lastly, the Koizumi administration has made progress in government deregulation and privatization. Bills such as the postal corporation privatization act have been passed after several
These reforms have reshaped the Japanese system and are said to have helped make the Japanese economy more market-driven. This structural change has also weakened the relationship between the yen/dollar rate and the economic indicators such as industrial production and the Tankan Index. This clearly signals that the Japanese economy is undergoing fundamental and unprecedented change.

It is my view that once the issue of the interest rate differential, which has been at the center of attention in the market for some time, fades away in the near future, the yen/dollar rate will start to decline. The appreciation of the yen will be underpinned by further signs of acceleration in the Japanese economy. Recent developments in the foreign exchange market already seem to reflect this change. The yen/dollar drifted down to the 113 yen level after payroll figures indicated that the US economy might not be as strong as earlier believed. This has fueled speculation that the Fed might end its tightening cycle as early as the end of January 2006.
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Sources: BOK, Monthly Bulletin, various issues.
BOK, Balance of Payments, various issues.
### Monetary Aggregates

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<th>M2 (%)</th>
<th>M3 (%)</th>
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<th>TB (3yrs, %)</th>
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#### Notes:
- **TB** = Treasury Bonds, **CB** = Corporate Bonds
- **CB** (Bil. won)
- **TB** (Bil. won)
- **KOSPI** (1980.1.4=100)
- **Total Market Value (Tril. won)
- **Daily Stock Tran. Vol. (Mil.shares)

### Interest Rates

#### Table

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<th>CB (Bil. won)</th>
<th>TB (Bil. won)</th>
<th>KOSPI (1980.1.4=100)</th>
<th>Total Market Value (Tril. won)</th>
<th>Daily Stock Tran. Vol. (Mil.shares)</th>
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### Notes:
- **TB** = Treasury Bonds, **CB** = Corporate Bonds
- **CB** (Bil. won)
- **TB** (Bil. won)
- **KOSPI** (1980.1.4=100)
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### Sources:
- BOK, Money & Banking Statistics, various issues.
- Korea Stock Exchanges.