

ASIAN WEEKLY ECONOMIC INSIGHTS



February 2, 2007

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Asian Economic Perspectives

South Korea 2007: Weak Economy to Restrain Rates and Won Gains

Interest rates and currency are the main themes of the economic outlook for South Korea this year, and we see limited upside risk in both. The Bank of Korea (BOK) is likely to find further hikes in the policy rate difficult to justify any time soon, following very weak December industrial production figures and a disappointing fourth-quarter 2006 GDP result. Indeed, consensus interest-rate forecasts have changed markedly with conviction no longer being attached to expectations of a near-term 25 basis-point increase in the overnight call rate. For those bullish about an externally-led recovery later in the year, the call for a rate hike has been pushed back to the second-half of 2007.

We maintain our view that the BOK will continue to focus on property-specific measures to deal with the risk of a real estate bubble, and keep the overnight call rate at 4.5% for at least the next two quarters. Global factors will be an important policy consideration. Our base-case scenario of a synchronized slowdown in the G3 economies in 2007 suggests that South Korea's interest rates will lean towards the downside as the year progresses.

As for the won (KRW), recent trends in South Korea's balance of payments have reinforced our view that KRW/US\$ will under-perform relative to other major Asian currencies in the next six months. However, we still see chances of a slight rebound of KRW/US\$ over a six to 12-month horizon, as South Korea's external account improves on better terms of trade and a possible resurgence of portfolio inflows.

Output Growth Plummeted...

Industrial output fell in December with month-on-month growth contracting significantly in most key product areas (**Display 1**), including

semiconductors, mobile phones and automobiles. The production downturn mirrors last month's export deceleration, indicating that weakness in US demand was the cause, offset by continuing firm export demand in the European Union and Japan. The leading-indicator index suggests production growth may stabilize and hover at a low level during the first-quarter of 2007. But there is no sign of a recovery in sight (**Display 2**).

...While GDP Growth Disappointed

Fourth-quarter real GDP growth decelerated to an annualized rate of just 3.4%. More importantly, the deceleration was spread across all key sectors. Capital investment showed no growth, exports contracted marginally and private consumption, while apparently better quarter-on-quarter, in fact merely stabilized after a marked slowdown in the first-half of 2006. Optimists (including the BOK) have been arguing for some time that a consumption-led recovery is likely, but recent trends suggest only a stable outlook even under the best-case scenario (**Display 3**).

A consumption-led recovery is certainly not the outcome indicated by recent trends in either employment and wage growth, or the consumer confidence index (**Displays 4 and 5**). The only good omen comes from the improvement in South Korea's terms of trade—the difference between export and import prices—because of the fall in international oil prices, to which the country's economy is particularly sensitive. This should enhance real income. In our view, however, the terms-of-trade improvement and its impact on South Korea's real income and consumption have been grossly overstated: we estimate, at best, a smaller contraction in income during the second-half of 2006 (**Display 6**). Of course, a sustained fall in the price of oil and other key commodities in the coming year should produce a more explicit positive effect on South Korea's terms of trade, but

is unlikely to be noticeable during the next six months.

BOK to Hold Rate Steady

House prices have recovered markedly during the past year and led to a corresponding rise in the level of rents (**Display 7**). The BOK—its room to manoeuvre on interest rates constrained by weakening real economic activity—has been addressing problems in the property market with sector-specific measures, such as tightening mortgage lending and penalizing borrowers who try to mortgage a second home. The central bank has also been trying to reduce excess liquidity in the banking system by, for example, raising commercial banks' reserve requirements (including those on foreign-currency deposits) and gradually liberalizing the capital account to encourage residents to invest offshore. For these reasons, we believe the BOK is cautious about hiking the overnight call rate as the economy slows. We maintain our forecasts for a policy rate stable at 4.5% during the next six months and a decline in local bond yields, assuming no continued sell-off in US Treasuries. Our six-month target for the five-year government bond yield is 4.7% compared to the current 5%.

Fear of KRW Strength Overstated

On the currency front, external flows will remain unfavorable to KRW/US\$ in the next three to six months, but the situation may improve slightly during the second half of 2007. In our view, one of the biggest misconceptions in Asian financial markets is that the KRW's sharp appreciation against the Japanese yen (up about 45% since end-2004) is the root cause of South Korea's deteriorating growth and balance of payments. South Korean export growth (in US\$ terms) has in fact outpaced its Japanese counterpart persistently since 2004, giving the lie to any loss of external competitiveness (**Display 8**). An important trend

that has always been overlooked is the fact that South Korean corporations have been the most aggressive foreign investors in China during the past five years in terms of production relocation and outsourcing. The benefit from China's labour costs and productivity must have more than compensated for the erosion of competitiveness caused by KRW/JPY appreciation.

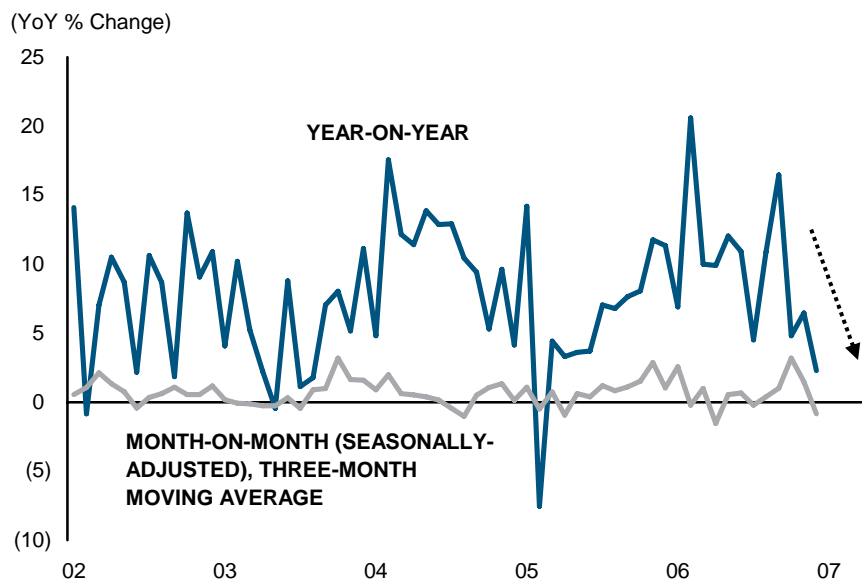
This is why we think the South Korean government's fear of KRW appreciation is overdone. Indeed, from a fundamental perspective, it is groundless. South Korea's current account surplus shrank to US\$6 billion in 2006 from US\$15 billion in 2005. The capital account ballooned to a surplus of US\$19 billion last year (from about US\$5 billion in 2005), but the increase was mainly due to a sudden surge in 'other' investments consisting of debt capital (mostly commercial banks' short-term borrowings). Net portfolio flows showed a large deficit of US\$22.5 billion while net foreign direct investment registered an outflow of US\$3.5 billion.

Looking ahead, we expect the current account to be virtually balanced in 2007, probably with a more noticeable improvement during the second half as the terms of trade further improve. Other investment flows began falling towards the end of 2006, and we expect these investments to show a substantial net outflow this year (**Display 9**). The only hope is that portfolio inflows will return as the local stock market becomes oversold. This trend, however, will be counteracted as residents, encouraged by the government, increasingly invest offshore. In short, we continue to see limited upside potential for KRW/US\$ during the next six months. The likelihood of a bigger bounce may increase as the year progresses, but the appreciation is unlikely to be more than 3% to 4%.

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Display 1: Output Has Fallen Significantly

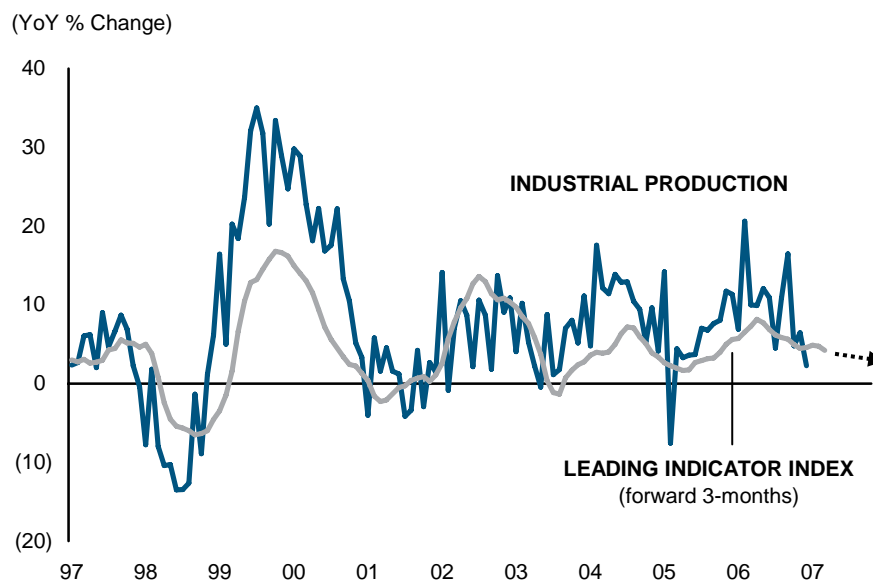
Korea Industrial Production



Source: CEIC Data and AllianceBernstein Fixed Income estimates

Display 2: Leading Indicator Points to Possible Output Stability in 1Q:2007

Korea Industrial Production and Leading Indicator Index



Source: CEIC Data and AllianceBernstein Fixed Income estimates

Display 3: Weak 4Q:2006 GDP Performance

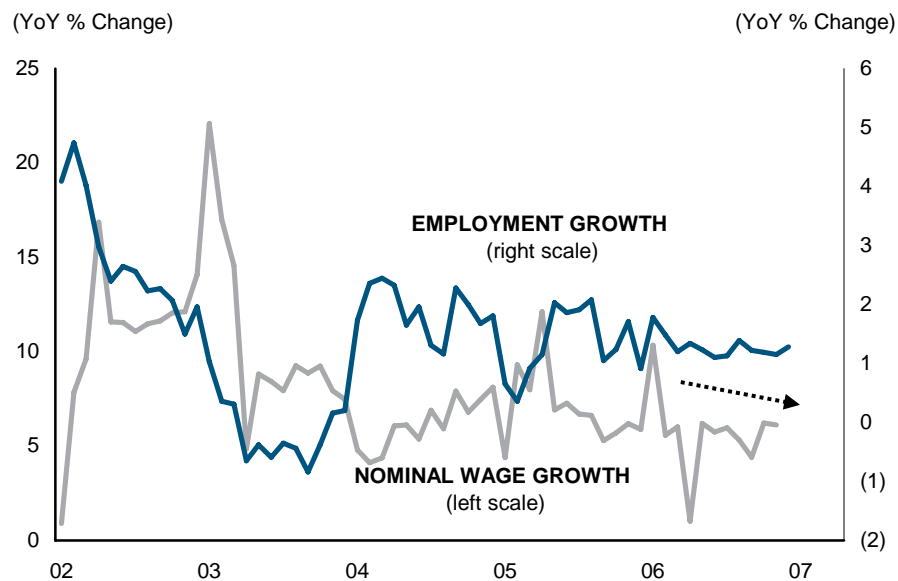
Korea National Income Account

(QoQ Annualized %)	2006			
	1Q	2Q	3Q	4Q
Real GDP	4.8	3.3	4.4	3.4
Private Consumption	5.1	3.7	2.5	3.2
Government Consumption	7.3	6.2	7.0	5.4
Fixed Capital Formation	1.2	(4.5)	12.2	7.3
—Construction	2.3	(15.5)	11.7	10.3
—Machinery and Equipment	(1.6)	10.1	14.0	0.4
Exports of Goods & Services	12.8	21.7	8.3	(1.0)
Imports of Goods & Services	18.2	21.5	9.0	(8.5)

Source: CEIC Data and AllianceBernstein Fixed Income estimates

Display 4: Employment and Wage Growth Suggest Steady Consumption

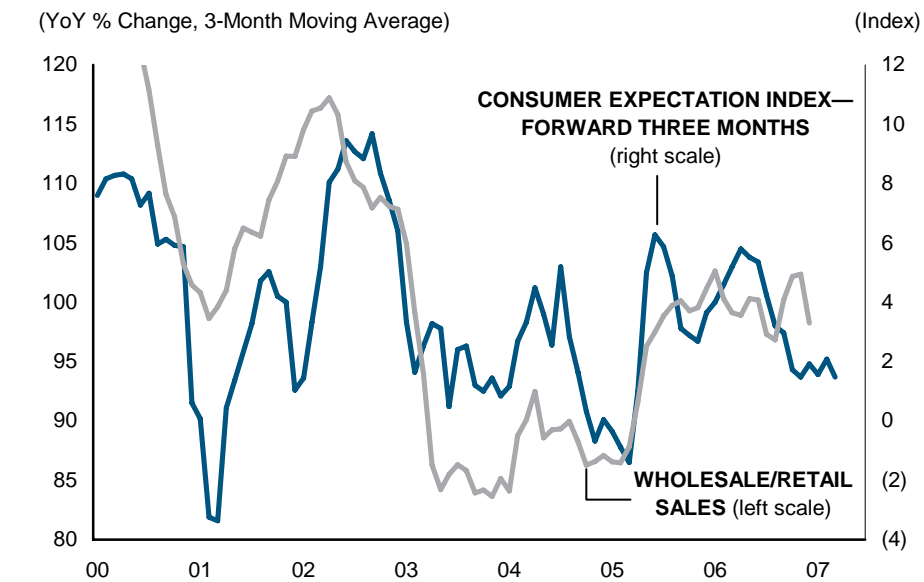
Korea Total Employment and Monthly Wages



Source: CEIC Data and AllianceBernstein Fixed Income estimates

Display 5: Consumer Confidence Remains Weak

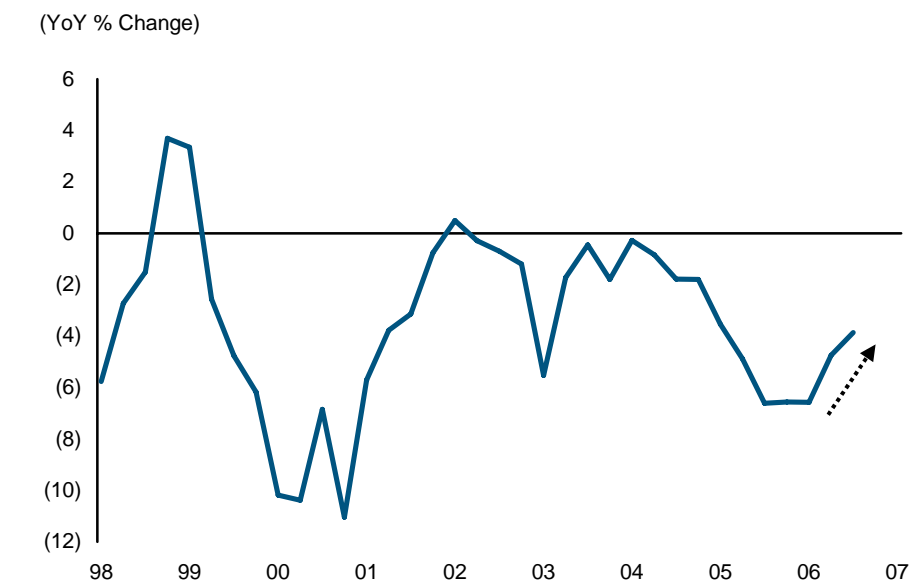
Korea Consumer Expectation Index and Wholesale/Retail Sales



Source: CEIC Data and AllianceBernstein Fixed Income estimates

Display 6: Terms of Trade Improve But Remain a Drag on Income

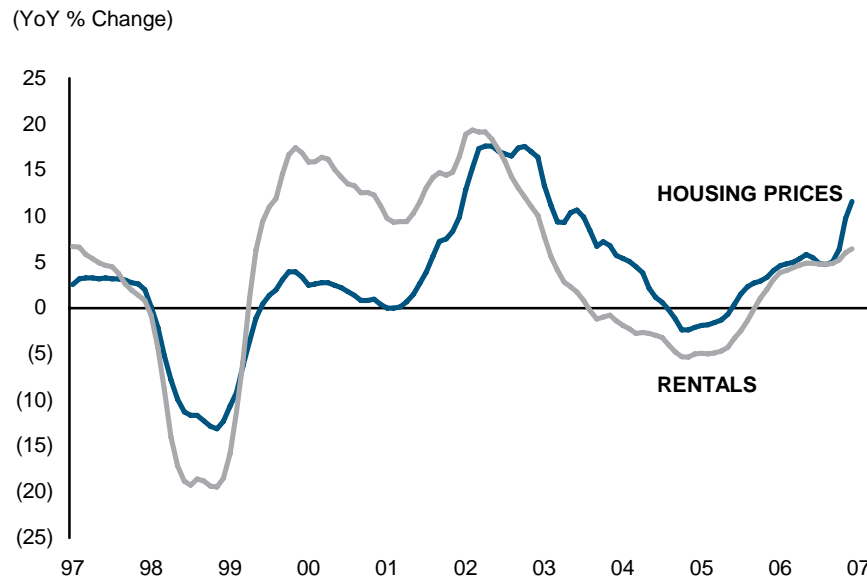
Korea Changes in Terms of Trade



Source: CEIC Data and AllianceBernstein Fixed Income estimates

Display 7: Upturn of Property Cycle Accelerates

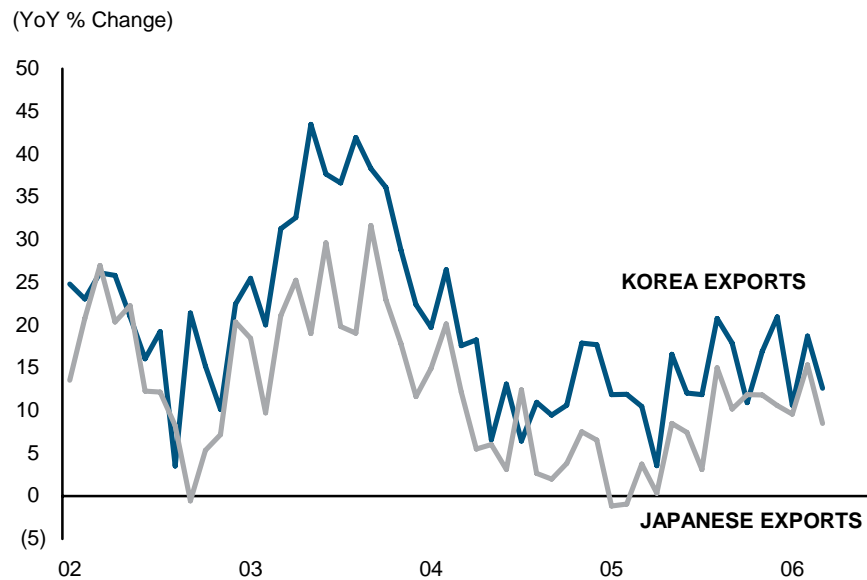
Korea Housing Prices and Housing Rents



Source: CEIC Data and AllianceBernstein Fixed Income estimates

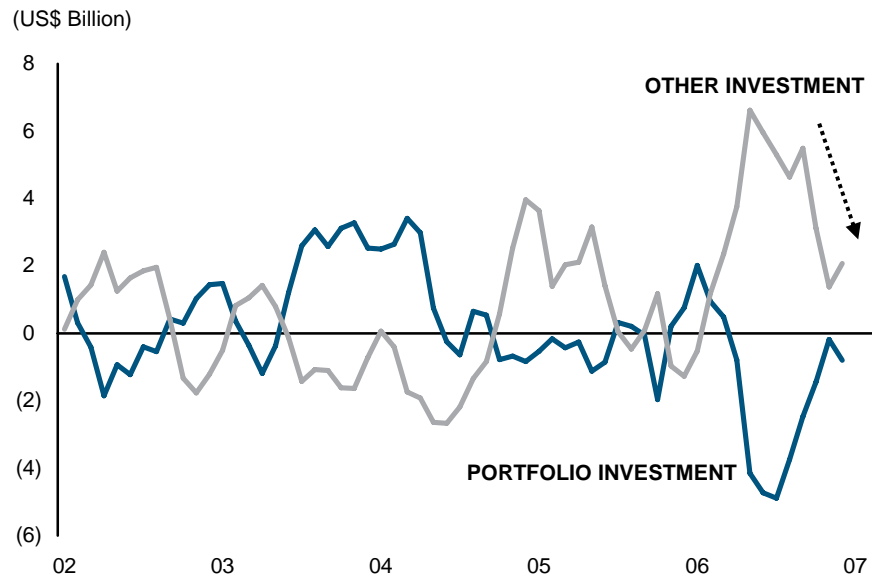
Display 8: Korean Export Growth Has Persistently Outperformed Japan's

Korea and Japan Export Growth (US\$ Terms)



Source: CEIC Data and AllianceBernstein Fixed Income estimates

Display 9: Other Investment Flows Have Already Receded Korea Net Capital Flows



Source: CEIC Data and AllianceBernstein Fixed Income estimates