

Summary

- We spent two days in Seoul last week, meeting with people from government, quasi-government, research institutes and the banking sector. Opinions and information gleaned corroborate our outlook for a soft landing in the economy this year. There is clear consensus that: Korea's GDP growth will likely slow to 4-4.5% this year from 5.0% in 2006, a tad below potential (widely believed to be about 4.5%). Most do not think that monetary or fiscal policy needs to respond aggressively to such a soft landing scenario. However, most are of the view that once property prices stabilise, policy will shift towards supporting economic growth. Thus, confidence in our forecast of one 25bps rate cut this year (regarded as fine tuning) has been bolstered.

Exports: cooler but still resilient

- Amongst the people we spoke with, concerns are widespread about the slowdown of exports due to softer global demand. It was nevertheless generally conceded that Korea's export mix is diversified both in terms of markets and products, and thus the export slowdown should be modest.
- During our meetings, we sought feedback about the double-digit export growth that was maintained throughout 2006, despite evident KRW appreciation. Some felt that Korean exporters were reluctant to raise product prices in the face of KRW appreciation due to the tough global competition. This however has depressed the profitability of Korean exporters. Some are more optimistic, pointing out that the pricing power of Korean exporters may not be so weak, as industries have been actively moving up the value chain. The surprisingly strong exports performance may also be indicative of the non-price competitiveness of Korean exports.

Domestic demand: seeking growth drivers

- We attempted to assess whether there domestic demand will be able to pick up the slack from weaker export growth. Most believe that public works should take up some slack, as the government intends to boost property supply in order to tackle the property price inflation issue.
- Other domestic demand components will likely come off slightly or remain stable this year. Facilities investment should stay in the same trend as exports, which is projected to show a mild slowdown. Apart from spill-over effects from softer external demand, short-term concerns over domestic demand also include the curbs on the property market (if there is over tightening) as well as the political uncertainties ahead of president election in Dec07. The former would dampen both investment in private construction and private consumption, while the latter may depress business and consumer sentiment. We also heard about structural issues, for instance, the worsening in the terms of trade, the rising number of job-seekers who have decided to exit labour market.
- In short, domestic demand is unlikely to rise and effectively offset an expected slowing in exports, but few seemed concerned that domestic demand would weaken sharply this year.

Tame inflationary pressure

- There is clear consensus on the inflation outlook. It is widely believed that inflation should stay tame – between 2%-3% this year (at the low end of BOK's target of 2.5-3.5%), so long as oil prices remain stable. Nevertheless, people still believe that headline CPI reading will likely be slightly higher than the 2.2% registered in 2006, mainly due to the widespread expectation of a slower rate of KRW appreciation this year.

Property inflation: wait-and-see

- We tried to figure out the factors leading to the property market boom in Korea. Answers offered to us include rising real demand due to economic recovery, Korea's transformation into a society of nuclear families, a mismatch between housing supply and demand, lax lending policies and speculation from short-term capital inflows (though there has been limited data to prove the latter case).
- As for solutions to the property market problem, people generally think that increasing property supply (the recent policy focus) should be a more effective and lasting solution, compared to previous measures which depended solely on

curbing property demand (mainly tax measures). Nevertheless, people are not very confident that the recent set of stabilization measures would be effective, with policymakers themselves expressing that the need for a review in the coming months.

- Nevertheless, our impression is that there is general relief over the recent easing in property prices, though it is merely on margin. In our view, the government's target might be preventing property prices from surging rather than pushing down property prices into a sharp decline. This also supports the view that there will not be over-tightening on the property market, which in turn would lead to a deterioration in domestic demand.

Monetary policy: neutral, in the near-term

- There is broad consensus that there will be no policy rate change from the BOK this year. The major factor hindering rate cuts remains property price inflation, as people are worried that interest rate cuts will fuel a resurgence in the property bubble, repeating what happened in credit card market in 2002. However, people also agree that policy priority will gradually shift towards supporting economic growth, once the property market has stabilised. Our view of a fine-tuning in monetary policy through one 25bps rate cut remains intact. The risks on our call lie in better-than-expected export performance and a rebound in property prices, which will mean that the rate cut would be delayed.
- During the meetings, we also tried to seek the view about the rationale of raising the reserve requirement ratio (RRR) instead of interest rate by BOK in Nov06, as the former should lift market interest rates eventually albeit indirectly. The explanation we got is that RRR hike should generate more direct impact on freezing liquidity and curbing bank loans, but indirect impact on fuelling KRW appreciation (which is a concern of policymakers, obviously). Given that continuous RRR hike will require BOK to raise call rate target eventually, people believe that RRR is unlikely to be used as a regular monetary instrument in future.

Fiscal Policy: neutral with mild expansionary bias

- The people we met generally think aggressive fiscal expansionary response is unlikely this year (for instance, tax cuts), even though this is an election year. Fiscal spending will likely expand moderately and be channelled to public construction, as a win-win strategy to both support economic growth and curb property prices.

KRW: less appreciation pressure

- There is also clear consensus on the KRW outlook: that it should appreciate less than the 8% it rose against the dollar last year. First, the current account surplus is likely to narrow, as services receipts are shrinking due to the KRW's appreciation (rising overseas travelling and education, etc) even though the merchandise balance is still holding up well. Meanwhile, the government is obviously trying to ease pressure on KRW appreciation, for instance, through encouraging portfolio capital outflows to overseas markets. When asked whether such measures will be effective against the expectation of rising gains in KRW-denominated assets, policymakers mentioned that promoting capital outflow to undervalued emerging markets might be a solution.

Recent research

KR: Field trip report	6 Mar 07	IN: Strong Growth in 1QFY07	2 Oct 06
TH: More rate cuts to come	23 Feb 07	TH: More Uncertainty	20 Sep 06
Singapore Budget: Key Initiatives	16 Feb 07	ID: BI To Keep Easing Momentum	4 Sep 06
IN: RBI springs yet another surprise	14 Feb 07	JP: Back in Deflation	24 Aug 06
CN: inflation risks rising	14 Feb 07	TW: Growth eases in 2Q on domestic demand	22 Aug 06
Singapore Budget: Something for Everyone	13 Feb 07	CN: An unprecedented bubble	17 Aug 06
MY-US FTA: Too Little Too Late	9 Feb 07	TH: 2006 GDP Revised To 4.9%	8 Aug 06
ID: BI - On Food and the Fed	6 Feb 07	ID: Time To Ease In Earnest	8 Aug 06
CN: Monetary Tightening To Speed Up	30 Jan 07	SG: Employment Outlook Remains Positive	3 Aug 06
IN: More Tightening Ahead	23 Jan 07	IN-SG CECA: A Win-Win Scenario?	2 Aug 06
TH: The Fun Has Just Begun	22 Dec 06	IN: Hits and Misses	24 Jul 06
SG: GST Hike - Impact on CPI and Policy	29 Nov 06	JP: Treading Carefully After ZIRP	20 Jul 06
SG: Stay Cautious	21 Nov 06	CN: Time for Tighter Policy Actions	18 Jul 06
CN: Can China Become the Next IT Giant?	17 Nov 06	TH: BOT to Stay Put	17 Jul 06
HK: Firm Footing	14 Nov 06	SG: Full-year Growth Still On Track For 7.0%	10 Jul 06
ID: BI - Ten Does Not Mark the Spot	9 Nov 06	ID: Rate Cut on the Cards Despite CPI	5 Jul 06
PH: Balancing Act - It's All About the Timing	9 Nov 06	TW: Policy Cycle Has Peaked	3 Jul 06
IN: INR Convertibility - Fiscal Roadblocks Ahead	8 Nov 06	IN: Inflation Watch	9 Jun 06
Asia: Who's Afraid Of An Electronics Slowdown	3 Nov 06	ID: BI To Take A Momentary Pause	5 Jun 06
TH: The Coup and After	1 Nov 06	IN: FY07 GDP Revised To 7.6%	1 Jun 06
CN: Consumption to Remain Strong	1 Nov 06	HK: Doom and Gloom Ahead? No	30 May 06
CN: After ICBC - what lies ahead?	19 Oct 06	JP: The End of Zero Interest Rates	29 May 06
Special Economic Zones: A Tale of Two Experiences	13 Oct 06	CN: Good Policy Moves – More Needed, More Coming	26 May 06
		SG: GDP Growth Revised Up to 7%;	24 May 06

Disclaimer:

The information herein is published by DBS Bank Ltd (the "Company"). It is based on information obtained from sources believed to be reliable, but the Company does not make any representation or warranty, express or implied, as to its accuracy, completeness, timeliness or correctness for any particular purpose. Opinions expressed are subject to change without notice. Any recommendation contained herein does not have regard to the specific investment objectives, financial situation and the particular needs of any specific addressee. The information herein is published for the information of addressees only and is not to be taken in substitution for the exercise of judgement by addressees, who should obtain separate legal or financial advice. The Company, or any of its related companies or any individuals connected with the group accepts no liability for any direct, special, indirect, consequential, incidental damages or any other loss or damages of any kind arising from any use of the information herein (including any error, omission or misstatement herein, negligent or otherwise) or further communication thereof, even if the Company or any other person has been advised of the possibility thereof. The information herein is not to be construed as an offer or a solicitation of an offer to buy or sell any securities, futures, options or other financial instruments or to provide any investment advice or services. The Company and its associates, their directors, officers and/or employees may have positions or other interests in, and may effect transactions in securities mentioned herein and may also perform or seek to perform broking, investment banking and other banking or financial services for these companies. The information herein is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation.