January 26, 2011 Emerging Markets unit

Summary: Korea's 2010 fourth quarter GDP grew by 4.8% y/y, broadly in line with expectations (consensus: 4.6%y/y; BBVA: 4.9%y/y), bringing full-year growth to 6.1%. On a quarterly, seasonally adjusted basis (non-annualized) growth moderated to 0.5% from 0.7% in the previous quarter, as manufacturing and construction slowed. The moderating trend was expected, following the very strong rebound in 2010H1, and is in line with our expectations of growth of around 4.5% in 2011, underpinned by strong domestic demand. It also provides further confirmation of strong regional momentum, following better-than expected Q4 GDP releases in China and Singapore last week. The policy focus in Korea has shifted from support for growth to containing inflation, which has picked up due to food and commodity price increases, as well as rising demand pressures. Following the Bank of Korea's rate hike earlier this month, we expect three more 25bp hikes during the remainder of the year.

Korea's Q4 growth remains strong, although momentum is moderating

- Korea registered robust GDP growth of 4.8% y/y in Q4 2010, compared with an outturn of 4.4% y/y in Q3. The outturn brings full-year growth for 2010 to 6.1% (BBVA: 6.1%), the strongest annual performance since 2002 (7.2%). On a seasonally adjusted quarterly basis (non-annualized), however, growth moderated to 0.5% (Consensus: 0.4% q/q sa; BBVA: 0.5% q/q sa), compared with 0.7% in the previous quarter.

- Slower manufacturing and construction output were the main factors for the quarterly slowdown. On the demand side, facilities investment decreased by 1.6%q/q because of a decline in machinery investment which had grown rapidly since 2009Q2, and construction investment declined by 4.5% q/q (Table 1 and Chart 1). The withdrawal of fiscal stimulus resulted in a reduction in government spending. On the positive side, exports increased 2.4% q/q and private consumption gained 0.3% q/q, after an increase of 1.3% q/q in Q3. For the whole year, domestic demand sharply recovered and contributed 7% to annual GDP growth, a turnaround from a 3.8% contraction in 2009.

- Inflationary pressures have been rising due to food and commodity price increases, as well as demand pressures. CPI inflation rose to 3.5% in December 2010, close to the upper bound of the government's inflation target range (2%-4%), although core inflation remains lower at just 2% (Chart 2). Bank of Korea has reiterated its focus on price stability, backed by government supply side administrative measures to tame price increases.

- Earlier this month, the BOK raised interest rates for a third time to 2.75% (Chart 3). We expect this trend to continue, with three more 25bp hikes to 3.5% this year. The authorities have also implemented macro-prudential measures to stem capital inflows, including the revival of a withholding tax on foreign investment in government bonds, tightened scrutiny of foreign-currency derivatives, and a proposed levy on foreign-exchange borrowings by banks.

Table 1: Growth Domestic Product by Expenditure

	2008	2009	2010^{p} 1Q	2Q	3Q	4Q	**2010**
Gross Domestic Product	2.3	0.2	2.1	1.4	0.7	0.5	**6.1**
(Private)	1.3	0.2	0.7	0.8	1.3	0.3	**4.1**
(Government)	4.3	5	5.8	0.1	-0.7	-0.7	**3.4**
Gross fixed capital formation	-1.94	-0.18	1.5	0.9	3.1	-3	**6.5**
(Facilities investment)	-1	-9.1	2.4	9.1	5.5	-1.6	**24.5**
(Construction)	-2.8	4.4	1.3	-3.6	1.3	-4.5	**-2.3**
Exports of goods & services	6.6	-0.8	2.9	7.2	1.7	2.4	**14.1**
Imports of goods & services	4.4	-8.2	4.4	7.4	2	0.1	**17.2**

Source: Bank of Korea

Chart 1: GDP quarterly growth by component

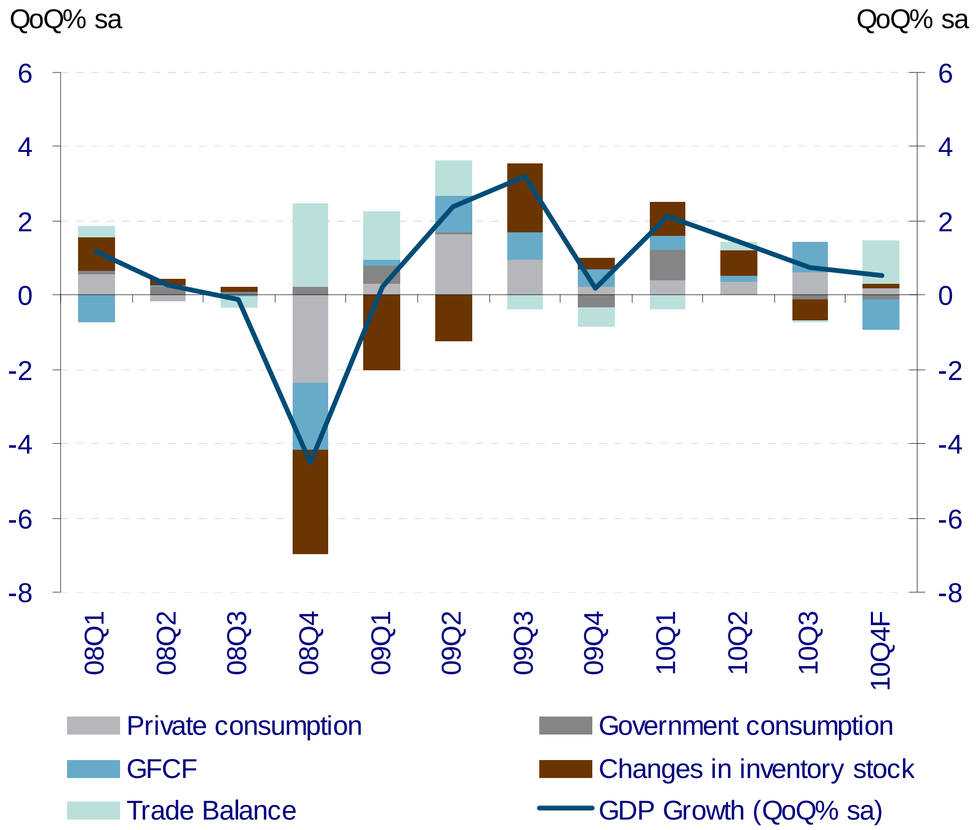
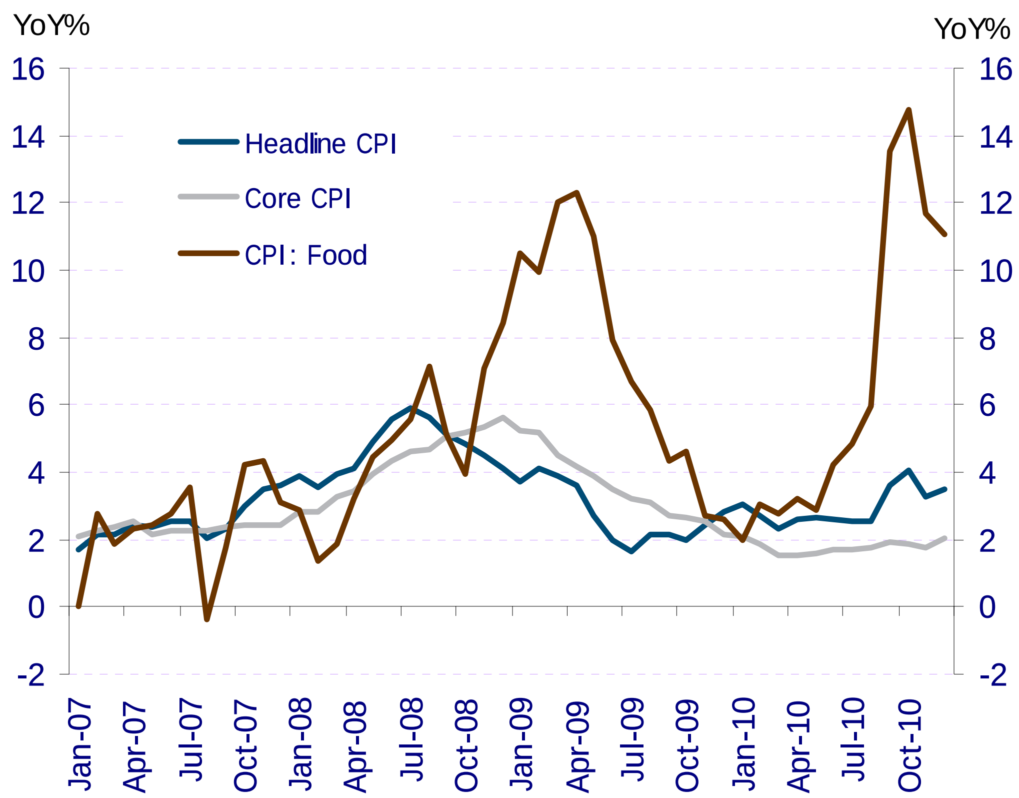
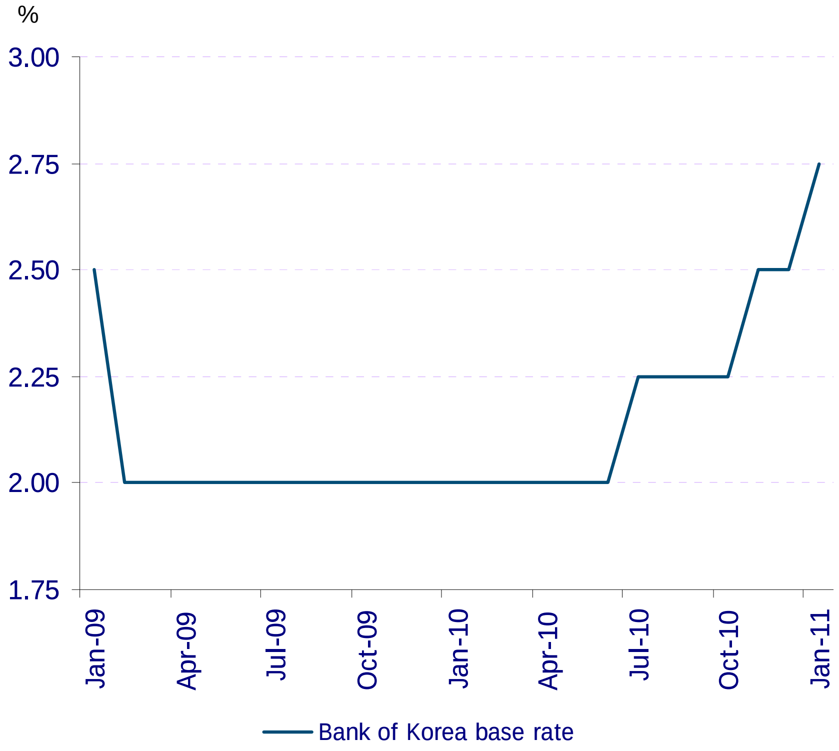


Chart 2: Monetary policy is on a tightening trend



Source: CEIC and BBVA Research

Chart 3: Monetary policy is on a tightening trend



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