CONTINUING ECONOMIC STAGNATION

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Business Cycle

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The cyclical component of the coincident index improved in September, and the leading indicator increased for the fifth consecutive month. Although the indicators forecast a recovery in the short term, the global uncertainty as well as worsened consumption and investment sentiment have made a recovery in the near term unlikely.

The GDP growth rate was 3% in the first half, and is not expected to exceed 1% in the third quarter. Although growth is expected to rise slightly in the fourth quarter, overall growth for the second half is not expected to exceed 2%.

Real Economy

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Production, shipments, and sales in September all increased from the previous year. Production rose 5.1% and the facility utilization rate for manufacturing was 74.9%, a 1.7% increase from August. Shipments rose 4.4%, and wholesale and retail sales rose 7.7%. This should not be seen as reflecting recovery in the real economy, because the number of working days in September this year exceeded that of last year.

The import decline has also moderated. While shipments for exports decreased by 3.0%, this was a marked improvement from the 10% declines in previous months. However, the world economy has yet to make a recovery, and trade frictions have emerged with Korea's main export markets such as Europe, making future export prospects uncertain.

A bigger problem is the continued decline in facility investment, which fell 6.1% in September, the eleventh straight month of decline. This was a reason for the delayed economic recovery, and a main factor in weakening potential economic growth.

Financial sector

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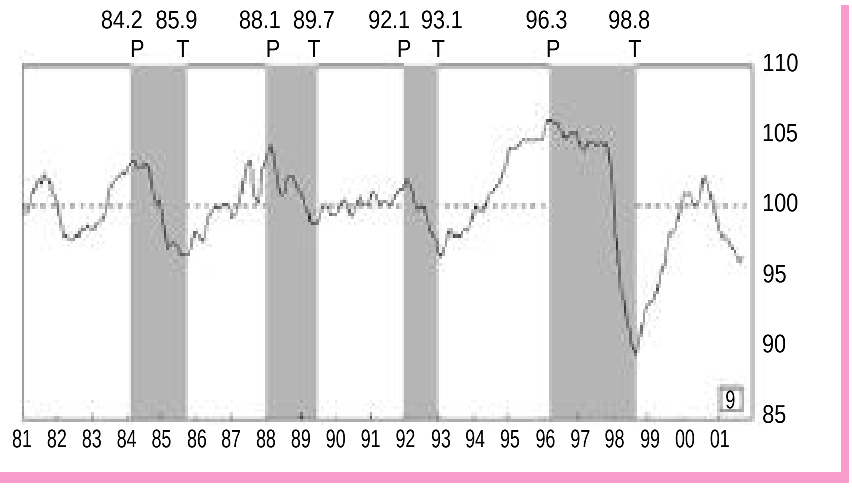
Figure 1. Cyclical Component of Coincident Index



exchange rate rose due to the strengthening dollar and the rising yen/dollar rate in the international financial markets. The strong dollar seems to be a market reflection of active US economic stimulus policy, and as a result the yen/dollar rate rose to 124 and the won/dollar rate also rose to the 1,300 level. However, the strong dollar trend is unlikely to continue in the near future, as uncertain consumer sentiment in the US is expected to dampen the dollar's rise. In this case, it is likely that the yen/dollar rate will fall again, which could lead to a fall in the won exchange rate as well.

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Market interest rates have shown a sharp uptrend due to anxiety in the bond market. Apprehensions about interest rate policies have severely contracted bond purchases, and this was due to conflicting policies between the Bank of Korea, which intends to increase liquidity, and the Ministry of Finance and Economy, which is conducting early repurchases of government bonds. The increasing trend of market interest rates is expected to continue for at least two or three weeks. After February's

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Figure 2. Recent Won/Dollar and Won/Yen Exchange Rates

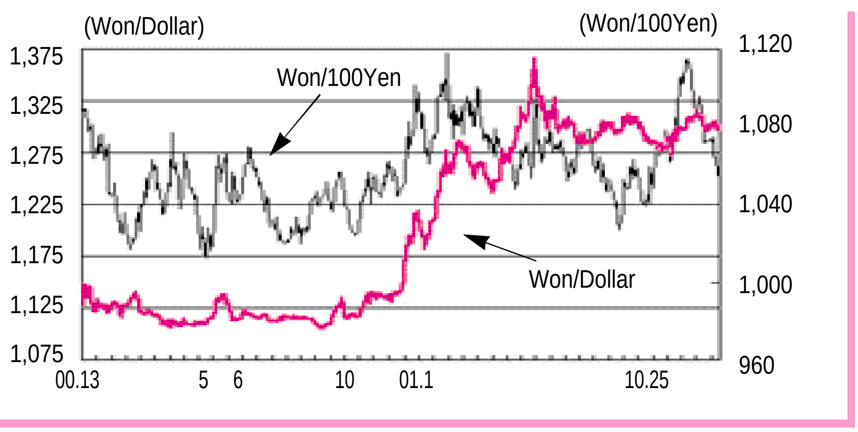
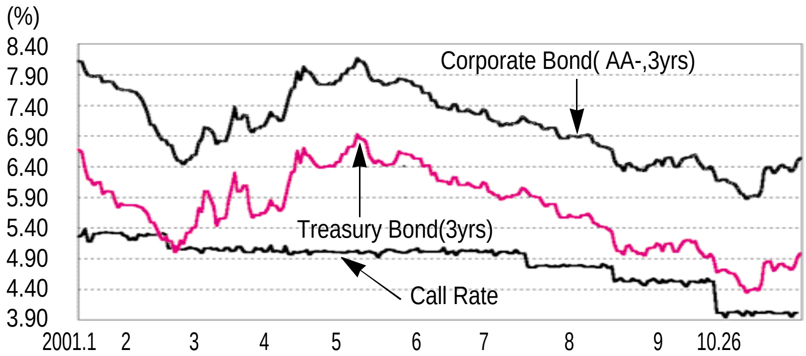


Figure 3. Key Interest Rates



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announcement of overheating government bonds, institutional investors suf fered considerable losses and are currently taking a conservative approach to asset management, and this is expected to keep bond purchases subdued in the short term. In addition, it is possible that the current interest rate uptrend will continue until the end of the year if the meeting of the financial and monetary committee at the beginning of November doesn't take a solid low interest rate position by actions such as additional cuts in the call rate.

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Stock prices showed a steady increase due to buying by foreign investors. Thanks to continued net buying by foreigners from October 15th to the 26th, the stock price index rose back to around 540, the level before the terrorist attacks in the US. Additional increases are unlikely however. The latest stock price upturn was a technical rebound taking advantage of low prices after what was perceived as an excessive decline in the wake of the terrorist attacks. Further rises based on fundamentals is unlikely considering the delayed recovery of the US economy. Therefore, the domestic stock market in the next few weeks is expected to remain steady at around 550. VIP

Figure 4. Korea Stock Price Index and Volume