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Employment has been relatively unscathed given the reduction in GDP. However, slower growth has affected the labour market through a cut in the number of hours worked. Lending conditions improved in the fourth quarter of 2009, but the worsening financial health of companies will hold back the recovery in investment. The financial and economic crisis has dented the potential growth rate of the German economy. This is now around 0.75% per year between 2009 and 2011.

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In late 2008-early 2009, South Korean banks proved extremely vulnerable to the global liquidity credit crunch while the deep economic contraction at home let fear a major deterioration in their asset quality. One year later, banks operate in a much better environment thanks to South Korea's strong growth rebound and significant improvement in its external liquidity position. The authorities have been very active in implementing a series of fine-tuned support measures, which have helped attenuate the impact of the global shock on the domestic economy and the banking system. As a result, banks' performance did not weaken in 2009 as much as initially feared. Their solvency remained sound, local- and foreign-currency liquidity rapidly returned to adequate levels and asset quality deterioration was not overly severe. The banking system still faces high credit risks stemming from persisting vulnerabilities in the SME and household sectors. However, overall, it seems on a good track to report an improving performance in the medium term.

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## Overview

### Worries are mounting

The European Commission this week approved Greece's plan to cut its budget deficit, which aims to bring the deficit to GDP ratio back below 3% in 2012. Measures relating to government revenues (abolition of tax exemptions, increasing excise duties on tobacco and alcohol, measures to combat tax evasion, reforms to enlarge the tax base etc.) are combined with major restrictions on spending (salary cut on recruitment - in addition to a pay freeze in 2010 – for civil servants, freeze on salaries of over €2,000, replacing just one in five civil servants entering retirement etc.). The Greek government has also made a commitment to implement structural reforms with the aim of improving the job market and facilitating investment, which should help to boost potential growth. However, the situation will be closely watched by the EU authorities. Greece is not expected to wait to take additional measures if its targets are not achieved and is required to submit a report on the progress made in the implementation of its plan in mid-March and again in mid-May. These provisions, while exceptional, have not been enough to calm the financial markets' concerns. The premium for Greek 5-year CDS, which was still below 400bp on Wednesday, has since risen considerably higher. As a reminder, the premium was less than 285bp at the start of the year and reached just 270bp the last time things heated up in March 2009. In addition, the easing of 10-year Greek government bond yields, which have returned below 6.65% after nearing 7.20% in the first week of January, is less due to fading tensions than to tensions spreading to Portuguese securities, whose yields have soared over the last few days, reaching above 4.70% at the end of the week compared with 4.20% on 27 January. The solidity of the eurozone has yet again been put to the test. The next victim in the current crisis could be Spain, weakened by the length of the property crisis and also facing major budget difficulties.

The fall in the EUR/USD exchange rate, at its lowest in eight months, partly reflects these concerns about certain eurozone countries' ability to stabilise their debt and even to finance their deficits. These concerns are combined with growing fears about the quality and extent of recovery both in the eurozone and the United States, resulting in a reduction in investors' risk appetite. As usual, this situation favours the dollar, despite questions about the US economy. A return to a EUR/USD exchange rate of less than 1.30 between now and the end of the year is now possible. The issue of sovereign debt within the eurozone is likely to continue to weigh down the single currency over the next few months, despite the confidence displayed by the EU authorities, governments, the European Commission and the ECB in the region's ability to overcome its problems with balancing out public finances.

During last Thursday's Council of Governors meeting, the ECB left its key rates unchanged and Mr Trichet stated that the economic outlook for the eurozone had hardly changed since the last meeting. Growth is expected to remain moderate and uniform this year in view of rising unemployment, low investment and the high level of uncertainty. The ECB President appeared confident about inflation, expecting inflationary pressures to be low in the medium term. Under these conditions, an increase in key rates seems unlikely before 2011. The ECB will also continue with its cautious withdrawal from unconventional monetary policy measures.

The US unemployment rate fell from 10% to 9.7% between December and January, but an additional 20,000 jobs were lost. Job cuts (non-farm payrolls) have been revised upwards by +600,000 for 2009, now standing at 8.4 million since the recession began in late 2007. However, the job market continues to stabilise. On the basis of a three-month moving average, the fall in non-farm payrolls was just 35,000 in January, having been well above 700,000 throughout the first quarter of 2009.

#### Interest and foreign exchange rates

	Thursday 4 February	Thursday 28 January	Highest in 52 weeks	Lowest in 52 weeks		Thursday 4 February	Thursday 28 January	Highest in 52 weeks	Lowest in 52 weeks
Libor 3-month	0.25	0.25	1.33	0.25	EUR/USD	1.3771	1.3963	1.5111	1.2528
10-year US Gvt'Bond	3.61	3.66	3.94	2.49	USD/JPY	89.55	89.90	100.69	86.07
Euribor 3-month	0.67	0.67	2.02	0.67	EUR/JPY	123.35	125.51	138.65	115.95
10-year Bund	3.19	3.23	3.66	2.92	EUR/GBP	0.8734	0.8650	0.9401	0.8438
Libor 3-month yen	0.26	0.25	0.66	0.25	USD/CHF	1.0643	1.0529	1.1902	0.9978
10-year JGB	1.34	1.28	1.56	1.23	EUR/CHF	1.4657	1.4702	1.5377	1.4590

Sources: Financial Times. Thursday's closing prices

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## Focus 1

### Germany: Facing the crisis

- Employment has been relatively unscathed given the reduction in GDP. However, slower growth has affected the labour market through a cut in the number of hours worked.
- Lending conditions improved in the fourth quarter of 2009, but the worsening financial health of companies will hold back the recovery in investment.
- The financial and economic crisis has dented the potential growth rate of the German economy. This is now around 0.75% per year between 2009 and 2011.

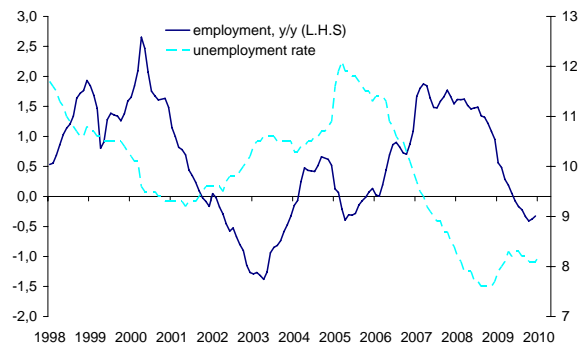
Germany was particularly hard hit by the collapse in international trade at the end of 2008. According to a Bundesbank study<sup>1</sup>, the financial and economic crisis will reduce potential output growth by at least 2 points cumulative between 2009 and 2011, taking it to 0.75% on average for this period. Adjustments to the labour market and low capacity utilisation rates, which hit investment, are both holding back potential growth. However, the real effect of the drop in output in 2009 on potential GDP and potential growth can only be measured ex post. If these adjustments persist, then the potential growth rate could remain low for some time to come.

#### Labour market reforms and the restructuring of companies in the mid-2000s boosted potential growth

Germany's potential output growth rate was estimated at 1.25% in 2006 and 2007. The reforms of the mid-2000s, under the Agenda 2010 (Hartz Act) programme, improved labour market flexibility by reducing the eligibility period for unemployment benefits, encouraging temporary work and the creation of new jobs in the form of "mini-jobs" and "midi-jobs"<sup>2</sup>. These measures bolstered the competitiveness of German companies and thence economic growth during the last growth leg of the cycle from 2005 to 2008 (total growth of 11%). The unemployment rate fell from 11.7% in 2005 to its cyclical low of 7.6% in November 2008 (see Figure 1). Meanwhile the Non-Accelerating Inflation Rate of Unemployment, or NAIRU, fell from 8.7% in Autumn 2005 to 8.1% by the end of 2008. It is also worth noting that the productivity of some of these new jobs, many of which were relatively unskilled, remained low. As result, the total number of hours worked began to rise in 2003 and gained more than 5% between 2003 and the cyclical high in Q3 2008. Moving in step

with strong GDP growth, total productivity per hour worked increased more than 5%, contributing to increase the German economy's potential output growth rate from the mid-2000s (see Figure 2).

Figure 1: Employment and unemployment



Source: Federal Labour Office

#### The limited fall in employment hides a significant drop in the number of hours worked

Employment fell by only 0.3% y-o-y in December 2009. Similarly, the unemployment rate rose very little given the scale of the economic contraction. In January 2010 it stood at 8.2%<sup>3</sup>, just 0.6 of a point higher than in November 2008. The costs of recruitment and redundancy, together with government support for companies making use of partial unemployment, have encouraged employers to retain workers pending a return to stronger growth. However, the slowing of economic growth has led to a reduction in the number of hours worked per employee of 4.4% between the cyclical peak in Q2 2008 and Q3 2009.

#### Manufacturing productivity also down

Given the collapse in manufacturing output it was no surprise that hourly productivity fell sharply in the first half of 2009. The latest figures indicate that the fall has been slowed (-4% y-o-y in Q3 2009 compared to nearly -9.5% y-o-y in the first half of 2009) thanks to an upturn in output and the greater use of mechanisms to allow a reduction in the number of hours worked (see Figure 2).

Although job losses have been limited (-0.2% y-o-y in Q3 2009 and +0.1% y-o-y in Q2 2009), they have been concentrated in the manufacturing sector (-3.4% y-o-y in Q3 and -2.2% y-o-y in Q2 2009) (see Figure 3), which accounts for around 20% of Germany's

<sup>1</sup> See the Bundesbank's Monthly Report "Outlook for the German economy-macroeconomic projections for 2010 and 2011", December 2009.

<sup>2</sup> See "German labour market survey", Conjoncture, November 2009.

<sup>3</sup> National data

total employment, has been hit hard by the collapse in international trade. Manufacturing output (excluding construction) fell by more than 15% in 2009, and the sector accounted for only 22% of total GDP in 2009 compared to 25% between 2005 and 2008 (see Figure 4). This marks a return to levels similar to those seen in 2004.

### A possible impact on the size of the labour force

The drop in employment, though small, could encourage a proportion of the unemployed to withdraw from the labour market, thus eroding the potential labour force through a reduction in labour market participation at a time when the labour force is already affected by a demographic decline<sup>4</sup>, having shrunk by 0.1% in both 2007 and 2006.

### Business investment likely to grow only slowly in 2010

Despite low capacity utilisation rates in manufacturing, investment in machines and capital goods rose by 0.8% q/q in Q3 2009 (after q/q falls of 18.5% and 0.5% in the Q1 and Q2 of last year). Capacity utilisation peaked at 88% at the end of 2007, before plunging to around 70% in Q2 2009 and then recovering slightly to 72% in Q3. Investment tends to be more closely correlated with the trend in capacity utilisation rates rather than the absolute level of the rate itself (see Figure 5). However, the utilisation rate will probably remain below its 2008 level, given the expected weak growth in GDP in 2010. As a result, investment is likely to remain distinctly lacklustre this year (rising 1.7%, having fallen 8% in 2009), particularly as financial conditions will do little to help.

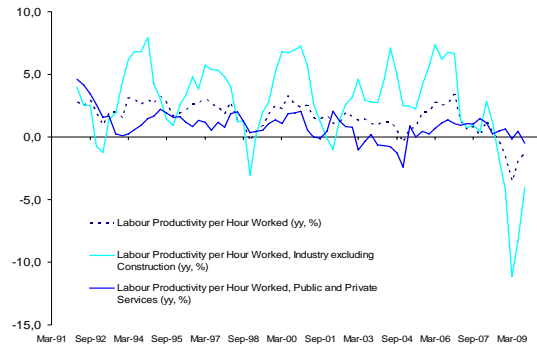
### Worsening financial health of companies will also hit investment

Business investment saw a slight upturn in Q3 2009 (see above) despite a fall in the volume of lending to companies at the end of last year. Loan volumes posted a year-on-year fall for the fourth consecutive month in December 2009 (-4.1% y-o-y from -2.2% and -1.5% y-o-y in November and October respectively) despite the improvement in lending conditions in the final quarter of last year<sup>5</sup>. Thus it seems likely that companies funded investment out of their own resources at the end of 2009 or directly borrowed in the capital markets, particularly as the Bundesbank survey shows that new loans were used primarily to help restructure existing debt or finance inventories (see Figure 6).

However, companies will not be able to self-finance investment over a protracted period. Weak economic activity and the increase in labour costs in 2009 have reduced their financial capacity. Whilst the partial unemployment scheme has allowed them to retain skilled workers and protect their human capital, the limited rise in

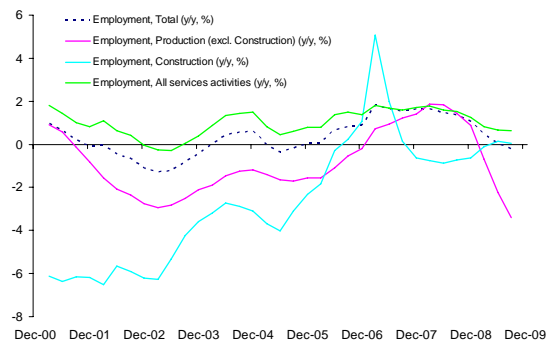
unemployment is affecting production costs and profitability despite government support. Wage costs accounted for 67.5% of net revenue in 2009, a 2.5 point increase on 2008.

**Figure 2: Productivity by sector**



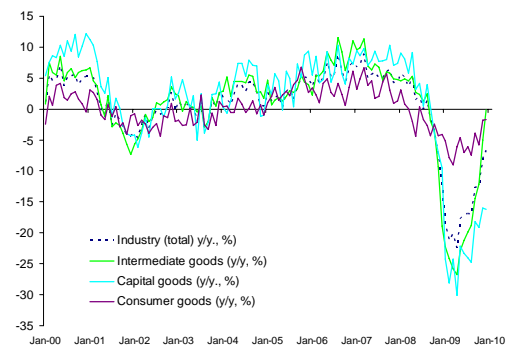
Source: Federal Office of Statistics

**Figure 3: Employment by sector**



Source: Federal Labour Office

**Figure 4: Industrial output**



Source: Federal Office of Statistics

<sup>4</sup> The labour force covers everybody in work and the registered unemployed.

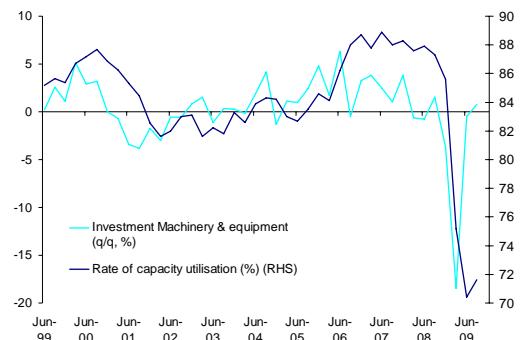
<sup>5</sup> According to the Bundesbank survey of lending conditions for companies over the next three months the index was at 0 in the fourth quarter of 2009, from a cyclical peak of 48 in the third quarter of 2008.

## Wage moderation is of little help

The two-year pay deals struck in 2009 (for the period 2010-2011) include limited wage increases. Hourly wages, which rose sharply in 2009 (up 2.7% y-o-y in Q3 2009, after 3% y-o-y in H1 2009), are likely to drop significantly in 2010 and 2011. Similarly, thanks to an increase in production in 2010, unit labour costs are also likely to fall (they rose 5.1% y-o-y in Q3 2009 and 8.3% y-o-y in the first half of 2009). But wage moderation will not allow companies to return to the profit levels seen in 2008. Economic activity will remain below its pre-recession levels. In addition, the price of imported goods, which tumbled in 2009 (down 8.4% having risen by 4.6% in 2008), will rise again this year, eating into company margins as they do so<sup>6</sup>.

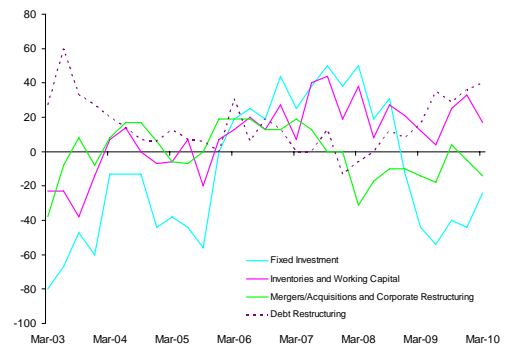
The shrinking of the labour force and the reduction in productive capacity (obsolescence of capital, lasting reduction in productive capacity<sup>7</sup>) will affect the level of potential GDP in 2010 and 2011. Granted, the measures taken during the recession have helped companies protect their human capital and the economy is seeing a return to growth. However, if growth is too weak (in which case investment in research and innovation could be sacrificed) and if adjustments in the labour market are delayed, there will also be a delay in returning to pre-recession potential output growth rates.

**Figure 5: Business investment and capacity utilisation rates**



Sources: IFO, Bundesbank

**Figure 6: Business demand for credit over the next three months (net balance %)**



Source: Bundesbank

<sup>6</sup> The rate of decline in import prices has eased since the summer of 2009. Import prices fell 13% y-o-y in July 2009 but by only 1% in December.

<sup>7</sup> The number of company failures rose by nearly 11% y-o-y in the first three quarters of 2009.

## Focus 2

### South Korea: The banking system has well withstood the crisis

- In late 2008-early 2009, South Korean banks proved extremely vulnerable to the global liquidity credit crunch while the deep economic contraction at home let fear a major deterioration in their asset quality. One year later, banks operate in a much better environment thanks to South Korea's strong growth rebound and significant improvement in its external liquidity position.
- The authorities have been very active in implementing a series of fine-tuned support measures, which have helped attenuate the impact of the global shock on the domestic economy and the banking system.
- As a result, banks' performance did not weaken in 2009 as much as initially feared. Their solvency remained sound, local- and foreign-currency liquidity rapidly returned to adequate levels and asset quality deterioration was not overly severe.
- The banking system still faces high credit risks stemming from persisting vulnerabilities in the SME and household sectors. However, overall, it seems on a good track to report an improving performance in the medium term.

South Korea's economy has rebounded surprisingly fast and strongly from the export collapse and widespread contraction experienced in late 2008-early 2009. The growth rebound is expected to be sustained in 2010. This environment has substantially helped the banking system pass through the difficulties of the last eighteen months.

In 2H08, banks entered the crisis with large foreign debt rollover and FC liquidity needs, which exacerbated their vulnerability to the USD liquidity crunch and sudden tightening of credit conditions. Since Mar09, ample support measures offered by the authorities and the turnaround in market confidence have rapidly improved the liquidity situation of the banking sector. Korean banks also entered the crisis with good capital ratios, which they have strengthened further over the past year, supported by the government's Bank Recapitalization Fund.

Regarding asset quality, the deterioration was less severe than expected in 2009 thanks to the early growth rebound and government support programs. Over the past year, the authorities have indeed provided massive fiscal and monetary stimulus to the economy, assisted the banking sector directly via liquidity and capital support measures and introduced programs aimed at

maintaining credit flows to viable firms facing temporary liquidity troubles and restructuring the weakest companies.

Continued growth recovery and government support measures should continue to contain banks' asset quality deterioration in the coming months. Credit risks remain a major cause for concern, especially because Korean SMEs and households are highly leveraged, the bulk of mortgages have floating rates and domestic interest rates are expected to rise in 2010.

#### 1. Key Indicators of South Korea

	2008	2009	2010f	2011f
Real GDP growth (%)	2.2	0.2	4.5	4.5
Inflation (CPI, average, %)	4.7	2.8	3.0	3.0
Fiscal balance / GDP (%)	1.2	-5.0	-3.0	-2.5
General government debt / GDP (%)	35.6	39.6	39.8	39.5
Current account balance / GDP (%)	-0.7	5.1	3.1	1.9
Forex reserves (USD bn)	201	270	330	370

Sources : Bank of Korea, BNP Paribas

### Macroeconomic conditions have very much improved over the past year

#### Impressive growth recovery after dramatic collapse

After three consecutive quarters of contraction in 4Q08-2Q09, real GDP growth accelerated from 0.9% year-on-year in 3Q09 to 6.0% in 4Q09. On a seasonally-adjusted basis, real GDP rose by 13.6% quarter-on-quarter (annualized terms) in 3Q09 and by a more moderate 0.7% in 4Q09. The first official estimate for real GDP growth in 2009 stood at +0.2%, down from +2.2% in 2008.

The Korean authorities have played a key role in supporting the economy in the aftermath of the global shock. In addition to an aggressive monetary loosening and an extensive program of liquidity and capital support measures for banks, strong public finances have enabled the government to implement rapidly a huge fiscal stimulus package (equivalent to 7% of GDP). Government spending and public investment in construction have rebounded strongly since the beginning of 2009 while fiscal incentives and public-sector job creation have helped household consumption revive. Similar trends are expected in the near term, especially because fiscal stimulus is due to remain in place this year.

Net trade gains have been another key engine of the growth rebound, as highlighted by the strong improvement in the trade balance in 2009 (chart 2). While both exports and imports contracted

sharply amid collapsing world demand in 4Q08, exports revived sooner and stronger than imports during 2009. They have been supported by the strengthening of Chinese demand (which now absorbs 24% of Korean exports) and global market share gains (especially in the electronic and auto sectors) resulting from the cheaper won (chart 3).

Even though the won has re-appreciated in recent months, exports are expected to continue to expand in 2010 as global trade should revive moderately and Korean goods continue to enjoy "intrinsic" competitiveness (resulting from strong R&D investment, continued upgrading of brand values...).

In Sep09, the industrial sector caught up with its pre-crisis production peak. Sources of the growth recovery have been gradually broadening over the past year. Business sentiment has been improving, the real estate market has rebounded and government programs to ensure continued bank lending to viable corporates have helped avoid a domestic credit crunch. All this has enabled private-sector investment to gain momentum since 2H09, a trend that should continue in the short term. Meanwhile, following a severe downturn in the inventory cycle in 2009, the economy is likely to benefit from substantial stock rebuilding in the coming quarters.

Economic growth is therefore expected to gain further momentum in the months ahead. At present, we are projecting real GDP growth at 4.5% for the whole of 2010.

### Rapid turnaround of the balance of payments

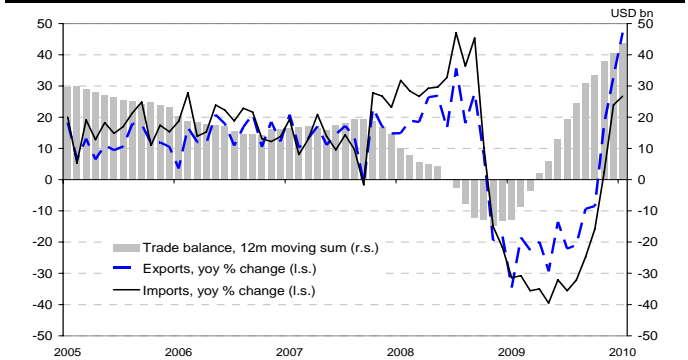
In line with the shift in the trade account, the current account balance returned to a strong USD43 bn surplus in 2009, up from a USD6 bn deficit in 2008. The capital account has also registered a dramatic reversal of previous dynamics since 2Q09. Both the government and large private institutions have enjoyed a renewed access to external debt markets (as illustrated by falling CDS spreads) while significant foreign portfolio investments have flowed back into both on the Korean equity and bond markets.

As a result, the won has re-appreciated rapidly since Mar09 and foreign exchange reserves have bounced back spectacularly. Their increase has been all the more significant as the central bank has intervened in the market to stabilize the exchange rate and counteract appreciation pressures, and as commercial banks have repaid the FC lines they had received via swap agreements with the central bank during the liquidity crisis.

Forex reserves reached USD270 bn at the end of 2009, exceeding the pre-crisis level and even representing a historic high point (chart 4). The rise in forex reserves and the reduction in short-term foreign debt orchestrated by banks have led to an improvement in South Korea's external liquidity and financial vulnerability indicators during 2009. In 2010, forex reserves are projected to continue to rise and the won to appreciate, still supported by continued capital inflows (all the more so as higher interest rates going forward could attract more

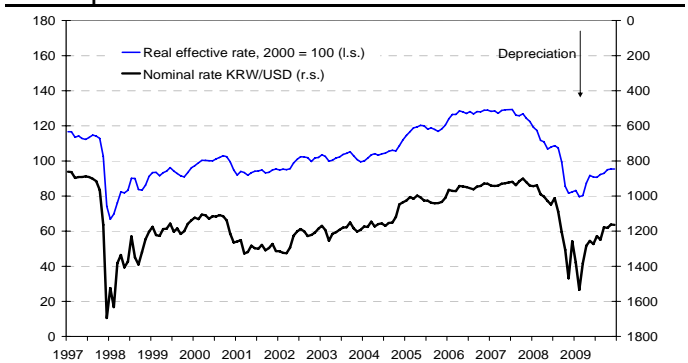
carry trade flows). The trade and current account surpluses are more likely to narrow on the back of rising imports.

### 2. Net trade gains



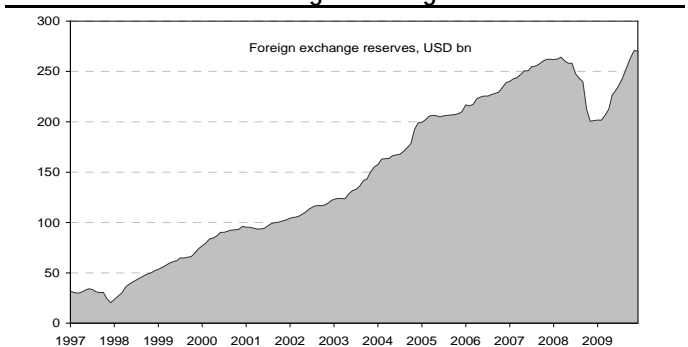
Source : CEIC

### 3. Competitive won in 2009



Source : IIF

### 4. Re-accumulation of foreign exchange reserves



Source : IMF

### Policy mix still supportive to growth in 2010

Last year's remarkable turnaround of the Korean economy was initially permitted by the comprehensive package of fiscal, monetary and financial policy responses put in place by the authorities during 2009. In 2010, economic policy will remain supportive to growth, even if some "normalization" in the policy mix can be expected.

Fiscal policy will remain expansionary, especially in the first part of the year as the government plans to front-load the execution of its budget. As a result of subdued tax revenue and larger spending, the government should report its second consecutive year of fiscal deficit, projected at 3% of GDP in 2010, vs. 5% in 2009. Widening financing needs are covered through active issuance of medium-long-term bonds on the domestic market and general government debt continues to grow (estimated at 40% of GDP in 2009). Yet, the authorities can afford some deterioration in public finances in the short term, as fiscal conservatism and surpluses posted during the years preceding the global crisis give it a good margin to maneuver to conduct counter-cyclical policy actions.

On the monetary front, the central bank has extended the annual CPI inflation target to 3.0% ± 1% for 2010-2012 from previously 3.0% ± 0.5%. This shift may help it maintain an accommodative policy stance for a longer time going forward and, indeed, the policy rate has been maintained unchanged at 2.0% until now, despite evidence of recovering GDP growth and increased inflation. In order to undertake a progressive exit from the exceptionally loose monetary conditions currently in place, the central bank is expected to start to raise the policy rate some time in 1H10.

Consumer Price Inflation has accelerated since Aug09, driven by increased prices of food, energy and transportation while core CPI has continued to decelerate until December (chart 5). CPI inflation averaged 2.8% in 2009 and is projected at 3.0% in 2010. Inflation pressures are likely to build up in the short term as domestic demand recovers and commodity prices rise, but should remain moderate, including due to currency appreciation.

## Banks have well resisted the recent economic and financial storm

### Banks' solvency still robust

Korean banks have maintained strong capital adequacy ratios over the past year, principally thanks to recapitalization efforts made in the aftermath of the global crisis. Banks resorted extensively to issuance of common equity, subordinated bonds and hybrid securities during 4Q08 and 2009, with the support of the government's Bank Recapitalization Fund. As a result, the average BIS capital ratio for commercial banks stood at a comfortable 14.3% as of Jun09, up from 11.9% as of Dec07.

### Banks' funding easier

After the deep liquidity crisis of late 2008-early 2009, the USD and KRW funding and liquidity situation of local banks has eased rapidly, thanks to the series of support measures offered by the authorities and then, starting in 2Q09, thanks to improving market confidence in Korean names. Banks have indeed been able to raise again USD funds from the global interbank and bond markets since Apr09, and this has even been done without resorting to the government's

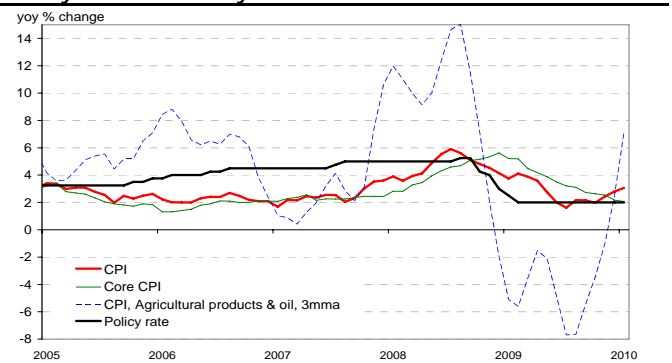
guaranteed FC borrowing program introduced in early 2009 (only one bank issued a bond under this program in 2Q09).

Banks have taken advantage of easier funding conditions to repay the FC liquidity funds they had received from the central bank and also improve the profile of their foreign debt by reducing its short-term portion. The latter trend has led to a reduction in domestic banks' FC refinancing risks.

Moreover, in late 2009, the authorities introduced new regulations aimed at strengthening banks' foreign exchange management and liquidity position – by setting short-term FC funding limits and minimum holdings of safe FC assets for banks and by limiting corporates' hedging positions.

Regarding local-currency funding, the situation has also improved since late 2008. It however remains an area of vulnerability for Korean banks, which are excessively reliant on wholesale funding and thus exposed to market volatility. Nonetheless, the balance between banks' deposit and market funding should improve in the medium term: the average Loan-to-Deposit Ratio (LDR), which already declined in 2009 (still being above 100%), should continue to improve as the authorities have recently set a regulatory limit for the LDR to 100%, due to be reached by end-2013.

## 5. Very loose monetary conditions



Source : CEIC

## Asset quality less damaged than initially feared

The average NPL ratio for domestic banks rose to 1.5% in Jun09, up from 1.1% at end-2008 and 0.7% at end-2007. It therefore more than doubled as a result of the crisis but, in the end, remains at a manageable level. As suggested by delinquency ratios, the quality of corporate loans, especially SMEs, worsened rapidly from 2008 until mid-2009 and since then has improved again. Meanwhile, the quality of loans to households, in particular mortgages, has proved resilient throughout the crisis (chart 6).

Of note, domestic bank credit represents 120% of total GDP in South Korea, of which more than 90% is geared to the private sector. As of Dec09, the corporate sector absorbed 55% of total loans to the private sector, including 8% for large corporates and

47% for SMEs. Households absorbed 45% of loans, including 30% for mortgages and 15% for others. The quality of loans to SMEs and mortgages is therefore a key factor determining banks' asset quality.

In the corporate sector: from a general standpoint, asset quality has deteriorated less than expected because the economy (the export sector in particular) has rebounded sooner than expected. Moreover, the government's support measures have been key to avoid a sudden deleveraging of corporates, which would have led to larger bad loans. As a result, while bank loan growth has decelerated rapidly since mid-2008, a domestic credit crunch has been avoided (chart 7).

At the behest of the authorities, Korean banks have made in-depth reviews of the weakest SMEs and large corporates, with the objective of restructuring the most fragile institutions while supporting the healthy ones. Banks have had to classify firms into categories. For non-viable firms, the government has been arranging for their restructuring or liquidation; most of them have been found in the construction, real estate project financing, shipbuilding and shipping sectors. Corresponding loans could turn into bad loans for banks, but their proportion has so far proved to be not so high.

In the best categories, firms are considered to be viable, but some of them might have experienced severe liquidity shortages due to the crisis. In such case, the authorities have conducted loan guarantee and SME support programs, aimed at requiring banks to rollover loans maturing in 2009, for another 12-month period. This probably greatly limited the rise in NPLs in 2009.

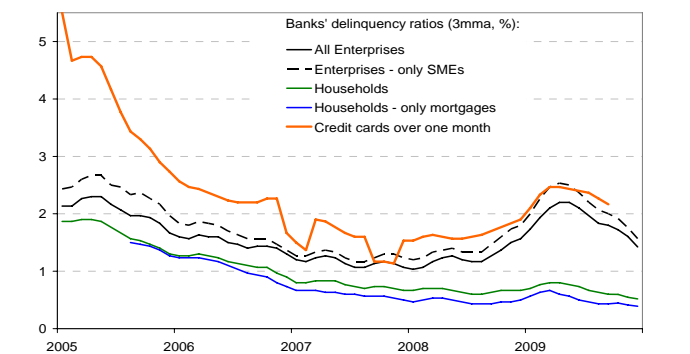
In the short term, new corporate NPLs are likely to emerge, principally because many SMEs still post weak credit fundamentals (high leverage levels, insufficient capital). Moreover, in the large corporate segment, one-off bad credit events cannot be excluded – like the liquidity problem of Kumho group, which was revealed last December. However, corporate loan quality deterioration in 2010 should still remain manageable thanks to several factors: i/ the manufacturing sector should continue to show resilience; ii/ large corporates remain financially sound on average, even if weaker than before the crisis; iii/ areas with "structural" problems have been clearly identified by the government and banks, and actions have been taken (in-depth risk evaluation, restructuring, early provisioning...); iv/ the government's recent decision to extend the SME support and loan guarantee programs to mid-2010 will continue to limit SMEs' refinancing risks a few more months.

In the household sector: loan quality has proved surprisingly resilient over the past year and households' debt servicing burden has not excessively worsened, largely thanks to the sharp decline in interest rates as well as to the modest deterioration in labor-market conditions.

The delinquency ratio of household loans rose slightly in late 2008-early 2009 but has then improved again and remained comfortably under 1%. The quality of credit cards, which were a major source of loan problems in 2003-2004, did not worsen excessively either in

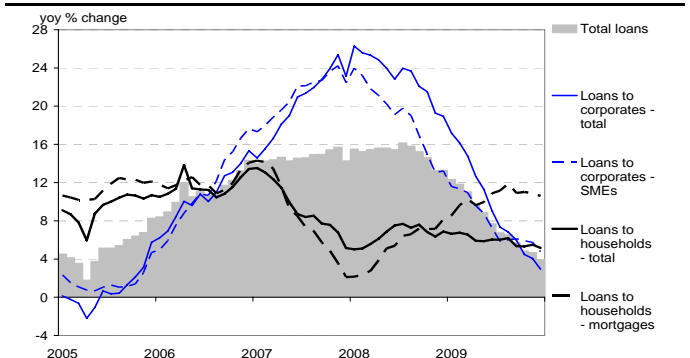
2009: the delinquency ratio on credit cards has not gone over 3% and has been on a downward trend since Mar09 (whereas it jumped to over 10% in 2003). The credit card industry indeed appears in a better health than in the early 2000s, mostly as a consequence of banks' tighter risk management systems.

**6. Delinquency ratios**



Sources : CEIC, FSS. Delinquency ratios denote delinquencies of one day or more on the principal of won-denominated loans.

**7. Mortgage loan activity resilient amid decelerating growth in total domestic credit**



Source : CEIC

**8. Commercial banks' key indicators: stronger capital ratios compensate for weaker profits and asset quality**

	%	Dec07	Dec08	Jun09
BIS capital ratio		11.94	12.72	14.25
Tier 1 capital ratio		8.45	9.01	10.50
Loan to deposit ratio (excl. CDs)		128.7	127.4	121.9
Return on Assets		1.08	0.54	0.31
NPL ratio		0.72	1.14	1.50

Source : Bank of Korea

On the back of very accommodative monetary conditions and the early rebound of property prices since 2Q09, mortgage lending strengthened continuously last year – contrasting with other categories of loans (chart 7). Korean households' average debt-to-

income ratio, which was already high, rose to 143% as of Jun09, up from 136% as of Dec07 – which is comparable to US/UK ratios.

In the short term, mortgages constitute a major source of vulnerability for banks: with 90% of domestic mortgages having floating rates, the monetary policy tightening expected in 2010 is likely to lead to consumer loan quality deterioration – even if banks are somewhat protected by the conservative mortgage Loan-To-Value ratio required by the authorities (40%-60%, vs. over 75% in the US/UK).

## Challenges still lying ahead

Compared with one year ago, South Korean banks have enjoyed normalization in their USD and LC liquidity position, maintained sound capital ratios and kept asset quality at a satisfactory level. Going forward, the improved economic environment should help banks' profitability recover from the decline reported in 2008-2009.

Meanwhile, banks will still have to deal with high credit risks due to continued vulnerabilities in the SME and household sectors. This is likely to maintain domestic credit growth at a moderate rate in the short term: total outstanding loans were up 4% yoy in Dec09 (1% in real terms) and are unlikely to accelerate much more in 2010 – contrasting with the three years preceding the global crisis, when average loan growth was closer to 14%. Notwithstanding high credit risks and modest loan growth, the NPL-to-total loan ratio is unlikely to rise excessively in the short term, as a result of banks' collection efforts, NPL write-offs and NPL sales to KAMCO (Korea Asset Management Corp, the government's "bad bank") or other institutions. The authorities have recently required banks to ensure that their NPL ratio remains close to 1% of total loans.

More generally, recent regulatory changes introduced by the authorities (NPL ratio at 1%, tighter rule for capital ratios, LDR below 100% by 2014) should lead the banking sector to make necessary efforts to report stronger fundamentals going forward. The coming years could also bring a wave of consolidation in the banking system, especially induced by the government's plan to resume privatization of some state-owned institutions.

## Recently released and forthcoming data and surveys

### United States

#### To watch from 8 to 12 February

Nominal **retail sales** declined 0.3% m/m in December, after progressing rapidly in October (+1.2%) and November (+1.8%, revised upward by 0.5 points). Excluding the most volatile categories (gasoline, vehicles, building materials), core retail sales dipped for the first time since July (-0.3% m/m). In **January** (figure to be released on Thursday, 11 February), total sales are expected to contract again, by nearly 1%, pulled down by the decline in automobile sales. Yet there is still a favourable underlying trend for retail sales. Gradual improvements in the job market and equity market gains provide support for households. In contrast, the credit market is still putting a damper on household spending, due both to tighter lending criteria and sluggish demand. This explains why households, after the holiday season, have concentrated purchases on basic needs.

#### From 29 January to 5 February

Gross domestic product				EcoFlash
Changes in %, q/q ann.	Q2 09	Q3 09	Q4 09	10-049
GDP	-0.7	2.2	5.7	
Private consumption	-0.9	2.8	2.0	
Public expenditure	6.7	2.7	-0.2	
GFCF	-12.5	-1.3	3.5	
equipment and software	-4.9	1.5	13.3	
residential	-23.2	18.9	5.7	

Source : Department of Commerce – Bureau of Economic Analysis (BEA)

Labour report (non farm sector)				EcoFlash
	November	December	January	10-061
Employment m/m, 000	64	-150	-20	
Manufacturing sector	-25	-23	11	
Private services	108	-69	48	
Unemployment rate %	10.0	10.0	9.7	
Hourly wages y/y, %	2.6	2.4	2.5	
Hours worked per week	33.2	33.2	33.3	

Source : Department of Labor - Bureau of Labor Statistics

Productivity and costs – Non farm sector				EcoFlash
Changes in %, q/q ann., sa	Q2 09	Q3 09	Q4 09	
Productivity	6.9	7.2	6.2	
Production	1.6	1.6	1.7	
Hourly wages	-1.1	2.2	7.2	
Unit labour costs	1.8	1.9	1.9	
Hours worked	6.9	5.5	1.5	

Source : Bureau of Labor Statistics

ISM surveys				EcoFlash
ISM - manufacturing	November	December	January	10-049
PMI	53.7	54.9	58.4	10-056
Production	60.2	59.7	66.2	
New orders	61.5	64.8	65.9	
Employment	49.6	50.2	53.3	
Prices	55.0	61.5	70.0	
<hr/>				
ISM - non manufacturing				
NMI	48.4	49.8	50.5	
Activity	49.6	53.2	52.2	
New orders	53.7	52.0	54.7	
Employment	41.7	43.6	44.6	
<hr/>				
Overall (M&N) (*)				
Composite index (*)	49.2	50.4	51.4	
Activity/production (*)	50.9	54.0	53.9	
Employment (*)	42.7	44.4	45.6	

Source: ISM - (\*) manufacturing and non-manufacturing : weighted sums according to sector weights within GDP

Personal income and spending				EcoFlash
Changes in %, m/m, sa	October	November	December	
Nominal income	0.3	0.5	0.4	
Nominal consumption	0.6	0.7	0.2	
Deflator (PCE)	0.3	0.3	0.1	
Core deflator	0.2	0.0	0.1	
Real income	0.0	0.2	0.3	
Real consumption	0.4	0.4	0.1	

Source : Department of Commerce – Bureau of Economic Analysis

## Eurozone

### *To watch from 8 to 12 February*

The significant rebound in the industrial sector pushed the eurozone out of recession in Q3 2008, with GDP expanding by 0.4% q/q in Q3 2009 after contracting in the previous five quarters. Available surveys and hard data reported that the ongoing bunch in activity should have continued in the last quarter of 2009. In **December, industrial production** should have continued to trend higher, rising by around 0.2%-0.3% m/m (the December figure will be released on 12 February), following the 1.1% m/m recorded in November. If confirmed industrial output should have increased by more than 1% on a quarterly basis. Under these conditions, **GDP** is likely to have expanded by around 0.4-0.5% q/q in **Q4 2009** (the flash estimate will be released on 12 February). GDP demand breakdown will not be available until the beginning of March. Nevertheless, available data signalled that private consumption should have remained rather lacklustre. On monthly basis, retail sales were flat in December, while on a quarterly basis they contracted by 0.3% q/q in Q4 2009, down for the seventh quarter in a row. New passenger car registrations did not record either a remarkable positive performance. Admittedly, they continued to increase in Q4 2009 (+1.3% q/q), albeit at a much slower pace than in the previous two quarters. Moreover, the latest data reported that car registrations contracted in November and December on monthly basis (-0.5% m/m and -1.6% m/m). This suggests that the impact of fiscal incentives for car purchases in some countries is fading. Investment, the most cyclical component of GDP and highly affected by the effects of the financial crisis should have continued to contract, albeit marginally. By contrast, exports are likely to have increased at relative strong pace, thanks to the revival of global demand. Imports are also forecast to have increased, albeit at slower pace with respect to exports, reflecting the weakness of domestic demand. As a result, net trade should have positively contributed to growth. Lastly inventories after adding 0.5 pp to growth in Q3 2009, should have contributed only marginally to GDP growth. Going forward, the pace of economic activity is expected to moderate. In January, the composite PMI for activity, a good leading indicator of GDP growth, was still consistent with expanding activity, but it eased for the first time in almost a year. This might signal that the eurozone economy is losing momentum. The transitory forces, such as fiscal stimulus and the end of the destocking process, which boosted industrial output in H2 2009, will not be felt any longer. Domestic demand should remain subdued over the coming quarters. Large spare capacities will strain investment decisions, while the ongoing deterioration in labour market conditions will weigh on household expenditures. By contrast, exports should continue to increase at a relatively significant pace, benefiting from a more

supporting external environment and from a more favourable exchange rate.

The **German economy** pulled out of recession in Q2 2009. GDP rose 0.4% q/q in Q2 2009 before accelerating to 0.7% q/q in Q3 2009. In the light of the statistics reported in recent months, **GDP growth** probably remained strong in **Q4 2009**, but slowed slightly compared to the previous quarter (figure to be released on Friday, 12 February). In full-year 2009, GDP contracted 5%, after expanding 1% in 2008, suggesting a slight slowdown in growth. With acquired growth of 3.9% q/q in Q4 2009 in November (vs. +5.4% q/q in Q2 2009), merchandise exports continued to boost industrial activity, up 0.4% in Q4 2009. Moreover, acquired growth of imported goods declined 2.2% q/q in Q4 2009, which means that net exports probably made a positive contribution to growth. Inversely, the decline in retail sales (excluding new car registrations) (-0.2% q/q in Q4 2009, after -0.4% q/q in Q3 2009) and the drop-off in car registrations since the end of the cash for clunkers programme (down 23% and 13% m/m, respectively, in December and November) signal another decline in private consumption in Q4 2009, which had supported German growth in H1. Yet, growth is expected to be weak in 2010. Exports should increase at a more moderate pace while higher inflation and rising unemployment, due to high unit wage costs, are likely to strain household consumption.

In **France, manufacturing production** rebounded 1.6% m/m in November after a 2-month decline, buoyed not only by strong growth in automobile production, but also by the increase in activity in other manufacturing sectors. Manufacturing surveys (INSEE business climate, PMI indexes) were still favourable in early 2010. Manufacturing PMI improved again in January, rising to a very high score of 55.4. The INSEE business climate index began rising again in early 2010, but held slightly below its long-term average. The number of business leaders reporting an increase in past business rose significantly in January (+7 points). Under these conditions, production is likely to have increased again in **December** (figure to be released Wednesday, 10 February). We expect **Q4 2009 GDP** to rise again (figure to be released Friday, 12 February), at a faster pace than in the previous quarter (+0.3% q/q in Q3). For the most part, the economic rebound will be driven by a smaller contraction in stocks and vigorous private consumption. Household spending rose strongly this winter with spending on manufactured goods up 3% q/q in volume, thanks notably to the boom in automobile purchases. Yet this surge was accompanied by a net rebound in imports. As a result, foreign trade should make a negative contribution to GDP growth, especially since customs data suggest persistently mild export growth in Q4 (after +1.7% q/q in Q3). After contracting rapidly for six quarters, investment could decline more moderately (-1.4% q/q in Q3), notably since employers are gradually showing greater confidence in the prospects of an economic

recovery.

**From 29 January to 5 February**

Eurozone – HICP					EcoFlash
Changes in %					10-047
		November	December	January	
Total	y/y nsa	0.5	0.9	1.0	
	m/m, sa	0.1	0.3	-0.8	
Core (1)	y/y nsa	1.0	1.1	#N/A	

Source: Eurostat (1) Excl. Energy, food, and tobacco.

(\*) Flash estimate - (\*\*) BNP Paribas estimate

Eurozone - PMI - Final estimate					EcoFlash
		November	December	January	
<b>Manufacturing sector</b>					10-055
	Headline index	51.2	51.6	52.4	10-051
<b>Services</b>					
	Activity	53.0	53.6	52.5	
<b>Composite activity index</b>					
		53.7	54.2	53.7	

Source: Markit Economics

Germany – Industrial production					EcoFlash
Changes in %, sa					10-062
		October	November	December	
Total,	m/m	-1.7	0.7	-2.6	
	y/y	-12.4	-8.0	-6.7	
Manufacturing,	m/m	-1.8	0.9	-2.8	
	y/y	-13.7	-9.0	-7.2	

Source : Bundesbank

Germany- Manufacturing orders					EcoFlash
Changes in %					
		October	November	December	
Total,	m/m	-1.7	2.7	-2.3	
	y/y	-8.3	1.3	6.4	
Domestic orders,	m/m	0.3	1.6	-1.4	
	y/y	-7.8	2.6	5.5	
Foreign orders,	m/m	-3.3	3.6	-3.2	
	y/y	-8.7	0.1	7.2	

Source : Bundesbank -- monthly changes are seas. adj.

Spain - Unemployment					EcoFlash
Monthly data					10-053
		November	December	January	
Job-seekers (000's)		3 869	3 924	4 048	
Monthly Δ (000's)		61	55	125	

Source : INE

Spain – Industrial production					EcoFlash
Changes in %, sa					10-059
		October	November	December	
Total industry	y/y	-9.1	-5.6	-1.4	
	m/m	0.2	-0.1	-1.1	
Consumer goods		-5.0	-0.8	1.0	
Capital goods		-12.7	-9.6	-8.2	
Intermediate goods		-11.0	-5.5	4.9	

Source : INE

## United Kingdom

**To watch from 8 to 12 February**

**Industrial output** increased by 0.4% m/m in November, after being unchanged the previous month, while manufacturing production remained stable. CIPS manufacturing survey outlined that activity recovery in the sector went on in December. CIPS headline manufacturing index reached its highest level in 25 months at 54.1. In addition, the output index, which remained above the 50-threshold for the seventh consecutive month, increased from 56.1 in November to 58.1, its highest level in more than two years. Industrial and manufacturing output should thus rise in **December** (data release on Wednesday 10 February) month on month. They should nonetheless remain below their pre-crisis levels as well as below the levels reached a year ago. In Q4 2009, however, they should increase by about 0.5% q/q, up for the first quarter in almost two years.

**From 29 January to 5 February**

Surveys in the manufacturing sector					Ecoflash
		November	December	January	10-050
CIPS manufacturing		#N/A	54.6	56.7	
Business confidence **		-21.1	-20.6	-13.7	
Total order books *		-45.0	-42.0	-39.0	
Exporting orders *		-37.0	-41.0	-33.0	
Stocks of finish goods *		20.0	15.0	13.0	
Output prospects in 3 mths *		4.0	-7.0	4.0	
Average prices *		-7.0	-6.0	8.0	

Source : CIPS - Markit , \*: CBI, \*\*: European Commission

Services Surveys					Ecoflash
		November	December	January	10-054
CIPS services		56.6	56.8	54.5	
Services confidence*		-33.7	-5.3	-14.3	

Source : CIPS - Markit , \*: European Commission

## Japan

### To watch from 8 to 12 February

For the moment, the recovery has not resulted in a pick up in investment demand. Substantial excess capacity, weak profits, and the uncertain outlook weigh on capital spending. Foreign and government demand are likely to have been the main support for machinery orders. In **December, core machinery orders** (leading indicator for private investment) are likely to have rebounded by around 7.5% (release on Wednesday, 10 February), but this follows a sharp decline in the previous month (-11.3%).

### From 29 January to 5 February

Industrial production				EcoFlash
Changes in % m/m, s.a.	October	November	December	10-046
Production	0.5	2.2	2.2	
Shipments	1.3	0.9	1.1	
Inventories	-1.5	0.4	0.0	
Inventory ratio	0.3	-3.4	-4.7	

Source : METI

Labour force survey				EcoFlash
Changes in %, cvs	October	November	December	10-046
Unemployment	5.1	5.2	5.1	
Ratio job offers-to-applicants	0.44	0.45	0.46	

Source : Cabinet Office

Consumption and household* income				EcoFlash
Changes in %, m/m, real terms, s.a.	October	November	December	10-046
Spending	-1.9	0.9	0.7	
Disposable income	0.8	-1.0	-2.1	

Source : Cabinet Office, \* Whose head of the family is salaried

Consumer prices					EcoFlash
Changes in %		November	December	January	10-046
<b>Tokyo</b>					
Total	m/m, s.a.	-0.2	-0.1	-0.5	
	y/y	-2.2	-2.2	-2.1	
Core *	m/m, s.a.	-0.1	-0.2	-0.8	
	y/y	-1.9	-1.9	-2.0	
<b>National</b>					
Total	m/m, s.a.	-0.2	-0.2	na	
	y/y	-1.9	-1.7	na	
Core *	m/m, s.a.	-0.2	-0.1	na	
	y/y	-1.7	-1.3	na	

Source : Cabinet Office, \*: excluding fresh food

Leading and Coincident indicators				EcoFlash
	October	November	December	10-060
Leading indicator	89,5	91,0	94,0	
Coincident indicator	94,3	96,0	97,6	
Lagging indicator	83,7	82,9	84,3	

Source: Cabinet Office

## Data Focus

### Employment report (January)

#### Payrolls down by 20,000 in January after decreasing by 150,000 in December

■ According to the “establishment survey” conducted by the Bureau of Labor Statistics (BLS), **non-farm payrolls contracted by 20,000 in January** after **-150,000 in December** (revised upwards from -85,000 in first estimate), i.e. less markedly than in any month since February 2008 excluding November (+64,000).

■ **Downward revisions on past data have been marked** due to the revision of the seasonal factor, since 2005 on the one hand and on the other hand the annual benchmarking of the level of past payrolls to implement new data from the government's unemployment insurance information. All in all, the number of payroll jobs lost during the past recession was 8.4 million.

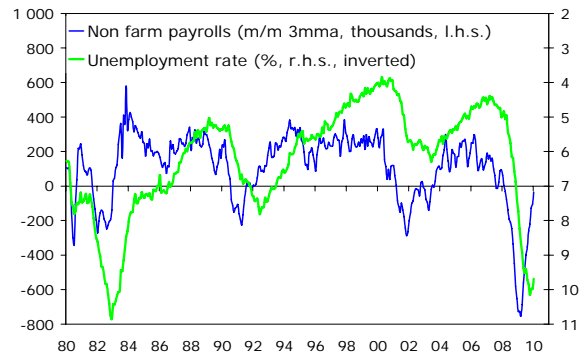
■ Given these factors and the fact that **January seasonal factor uses to be large**, **January figures are difficult to analyze**. **Nonetheless the gradual improvement in labour market conditions in the beginning of this year is confirmed**. The contraction in non-farm payrolls declined to 35,000 on a three-month moving average, while it was larger than 700,000 during Q1 2009.

■ **Payrolls are expected to increase again a few months from now**. Between February and May government payrolls will contribute to this favourable trend, as tens of thousands of temporary workers will be hired in order to conduct the ten-yearly census.

■ According to the “household survey”, **the unemployment rate decreased from 10.0% in December to 9.7%**. This positive evolution was mainly due to the sharp rise in employment (+541,000). A significant gain in employment (somewhere between 100,000 and 150,000 jobs per month) is generally necessary to stabilise the unemployment rate.

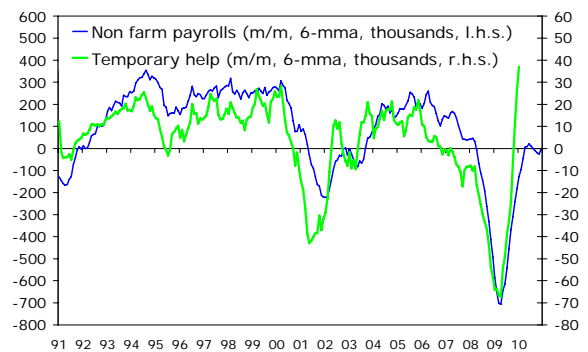
■ Hourly wages edged up by 0.2% m/m in December, so that their year-on-year pace of growth edged down further, to 2.5% from 2.4%.

#### Non-farm payrolls



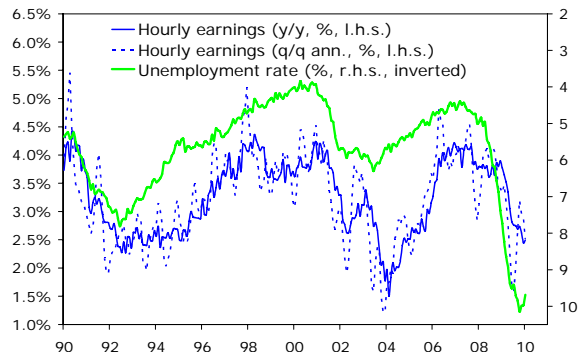
Source: BLS

#### Temporary jobs



Source: BLS

#### Unemployment rate and hourly wages



Source: BLS

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