

Executive Summary

Since AMRO's last Annual Consultation Visit to Korea in November 2024, the martial law declaration in the subsequent month and the political gridlock that followed weighed heavily on the country's investor and consumer sentiment. GDP growth bottomed in the first quarter of 2025. Since then, the economy has started to recover in the wake of the June presidential election, which ushered in an administration that pursues a more proactive policy stance. The new government employed various policy levers to support the economy amid heightened global trade tensions, while also seeking to preserve external stability and cool the Seoul housing market, which has seen substantial price increases in recent months.

1. **Korea's economy rebounded in 2025.** The recovery has been underpinned by a rebound in private consumption, owing largely to the resolution of political gridlock and fiscal stimulus. Exports, particularly semiconductors, have provided additional momentum. Construction investment, however, remains a drag, mired in real estate project finance (PF) distress. Growth is projected to rise to 1.9 percent in 2026, gradually narrowing the negative output gap.
2. **Inflation has remained well-anchored near the Bank of Korea's 2-percent target.** Less volatile food prices and muted energy prices have helped keep inflation around the BOK's target. Looking ahead, inflation is forecast to remain stable, averaging around 1.9 percent in 2026.
3. **The BOK has kept the policy rate on hold since May 2025.** While both core and non-core inflation have been relatively well-anchored, the Base Rate has not been further cut due to the authorities' financial stability concerns stemming from rising house prices and household leverage. Moreover, bouts of exchange rate pressure in recent months have bolstered their case for maintaining the current monetary stance.
4. **The external sector continues to be strong.** The current account surplus increased further in 2025, driven largely by semiconductor exports. Net outflows in the financial account persisted on the back of residents' portfolio investments and direct investments abroad. Foreign reserves remain ample, at around 2.6 times short-term external debt. At the same time, the won exchange rate has been volatile and depreciated against major currencies, reflecting continued net capital outflows and portfolio reallocation by residents.
5. **The government implemented two supplementary budgets in 2025 to support economic recovery.** The managed fiscal deficit, which excludes the balance of social security funds (SSFs), is estimated at 4.3 percent of GDP, higher than the originally budgeted deficit of 2.8 percent and the actual deficit of 4.1 percent in 2024. The fiscal stance is assessed to have shifted to slightly expansionary after the supplementary budgets.
6. **Although Korea's overall exports appear resilient, it is largely due to robust exports of semiconductors.** Potential changes in the US tariffs on semiconductors could affect Korea's exports even amid the global AI boom. At the same time, Korea's non-semiconductor exports have been affected by US tariffs and will likely remain vulnerable. Moreover, growth

slowdowns in Korea's major trading partners may dampen global demand and the outlook for Korea's exports.

7. **House price increases in certain districts in the capital region have raised concerns that prices may have risen beyond market fundamentals.** Potential abrupt downward corrections could negatively impact the financial sector.

8. **While NBFIs' exposure to PF loans has declined following restructuring efforts, and their capital and liquidity buffers remain adequate on average, lending to the construction and real estate sectors and NPL ratios for these sectors remain at relatively high levels.** Given the continued weakness in the regional real estate markets, the pace of restructuring and resolution for the remaining higher-risk distressed projects among smaller regional NBFIs may moderate.

9. **The current monetary policy stance is appropriate given the complex balance of risks.** While output growth remains suboptimal and inflationary pressure appears contained, financial stability concerns stemming from rising house prices and household leverage, combined with an improved outlook following the US-Korea investment and trade agreement, warrant maintaining the current monetary setting in the near term. That said, further easing may be considered if downside risks to growth were to increase due to a deteriorating external environment.

10. **Macroprudential measures to cool the housing market and contain household indebtedness should be complemented with more emphasis on adequate supply expansion.** The imposition and tightening of mortgage loan limits, along with the reduction of LTV ratios, should help dampen housing demand. Meanwhile, the plan to expand housing stock over the next five years was a positive development on the supply side. To complement the intended expansion, it may be beneficial to consider relaxing restrictions on reconstruction and redevelopment in high-demand districts. A multipronged strategy that encompasses education, health and transport policies may be needed to alleviate demand-supply imbalance in the capital region's housing market in a sustainable manner.

11. **The fiscal stance envisaged in the 2026 budget is broadly appropriate, with room for an expansionary fiscal shift should downside risks materialize.** Korea retains moderate fiscal space, and with monetary policy constrained by lingering concerns over household debt and exchange rate stability, the authorities should swiftly deploy well-targeted fiscal measures if adverse shocks to growth emerge. Once economic stability is restored, these temporary measures should be phased out in a timely manner to maintain fiscal credibility. Moreover, the authorities are advised to establish a credible fiscal anchor and advance structural fiscal reforms to ensure long-term fiscal sustainability, given concerns about the persistently rising debt trend.

12. **To maintain technological leadership and reinvent growth of the semiconductor industry, Korea needs to evolve from being the world's memory factory to becoming a full-spectrum semiconductor powerhouse.** Korea is well-positioned to build on its past success by leveraging existing strengths, which include in-house knowledge and process technology, strong commercial R&D, and a deep talent pool of STEM graduates.