



Residential

Seoul, Korea



The Residential Market

With house prices rapidly declining in many countries, there is a growing anxiety in Korea that the Korean housing market will follow suit. Although a softening in activity is inevitable, we believe a severe downturn is unlikely. Overall, Korea has not experienced a price bubble, prices are broadly in line with fundamental values, and loan to value ratios are low. Provided the economy begins to recover in mid-2009, we expect a corresponding improvement in Korea's housing market from the second half of next year.

Overview of Korea's Residential Market

The majority of Korea's housing has been constructed over the last 20 years, with the total housing stock having more than doubled since 1985. The rapid increase in the number of houses partly reflects population growth, but has been primarily driven by ongoing declines in the average number of persons per household, which fell from around 6.5 in 1985 to 3.5 at present. Most of the new housing construction has been of apartments, which now account for just over half of all homes in Korea (the ratio is similar in Seoul). Over recent years total annual stock additions have averaged around 500,000 and government targets are for a similar level of completions each year up until 2012.

Recent Developments

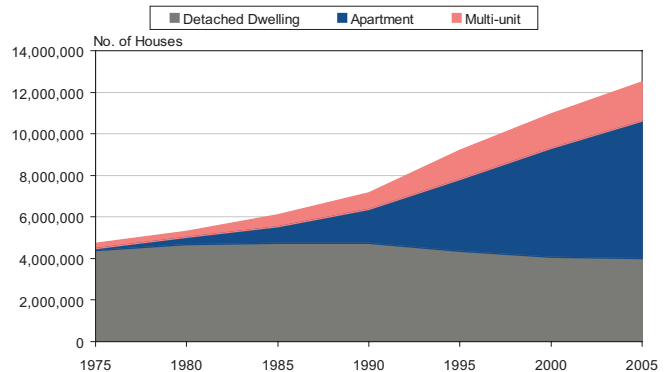
Following a period of decline in 2004, house prices in Korea increased strongly in 2005 and 2006, though at a more moderate rate, prices continued to rise up until the third quarter of 2008. In total average prices for Seoul and Korea rose by 43 per cent and 25 per cent respectively between January 2005 and October 2008. Key drivers included relatively low interest rates, solid employment and wage growth, expectations of future price increases, and in key urban areas, an ongoing shortage in supply. Other factors, such as school zoning and the location of elite private educational facilities, further contributed to price pressures in a number of popular residential areas in the Seoul Metropolitan Area (SMA), with average prices across the so-called "bubble seven"¹ areas jumping 50 per cent between January 2005 and December 2006.

Responding to public concern about the possibility of a house price bubble, the Korean government released a series of real estate policy packages between 2005 and 2007. These packages aimed to limit short-term swings in house prices by increasing supply and reducing "speculative" demand. Demand dampening measures included higher real estate taxes, stricter ceilings on mortgage loans (particularly for property purchases in areas designated as "speculation zones"), and price caps on new houses. Although average prices continued to rise, the government's counter measures – which were aided by weakening economic conditions and rising finance costs - appeared to have been successful in moderating the rate of house price growth. Moreover, prices across the "bubble seven" zones in Seoul have been flat or declining since the beginning of 2007.

How will the global credit crunch and associated economic slowdown affect the housing market?

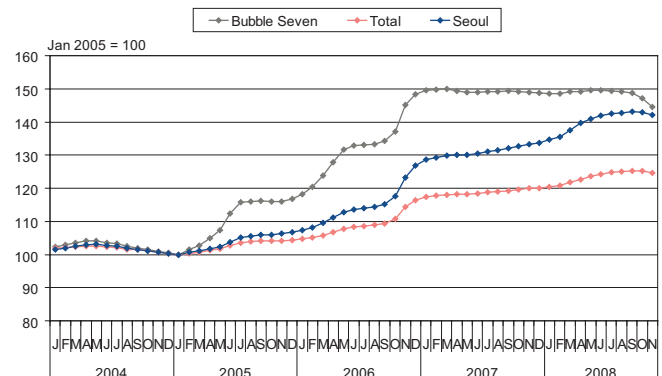
Over the last few months there has been a sharp deterioration in sentiment surrounding Korea's housing market. Contributing factors to the growing pessimism include high levels of uncertainty, weakening domestic economic conditions, and a sharp tightening in credit conditions. An additional factor has been the ballooning stock of unsold houses, particularly in non-metropolitan areas.

Total Housing Stock by Type, 1975 - 2005



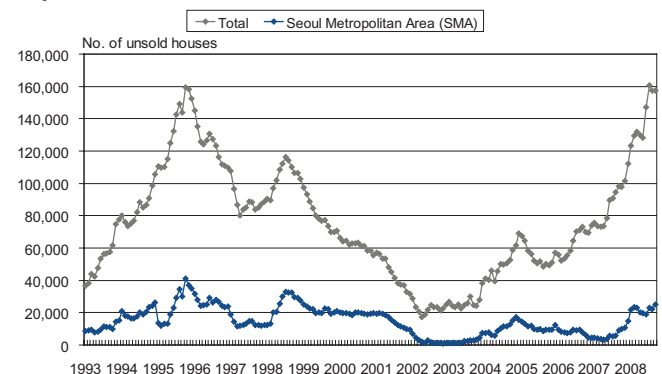
Source: Korea National Statistical Office

Average House Prices, January 2004 - November 2008



Source: Kookmin Bank

Number of Unsold Newly Built Houses, January 1993 - September 2008



Source: Ministry of Land, Transport and Maritime Affairs

¹ The so-called "bubble seven" is made up of the following districts: Guangnam-gu, Seocho-gu, Songpa-gu, Mok-dong, Bundang, Pyungchon and Yeongin.

The number of unsold houses began to increase rapidly in mid 2007 as developers rushed to complete apartments to avoid new price caps that took effect from September 2007. Buyer uncertainty has exacerbated the situation, with the total number of unsold houses reaching 25,000 in the SMA and 160,000 nationally at the end of September 2008².

The recent change in market sentiment is already visible in the data with September apartment sales in the SMA 20 per cent lower than a year earlier, and month-on-month average transaction prices falling 0.5 per cent in Seoul and 0.4 per cent for overall Korea in November. This is the first time month-on-month average transaction prices have fallen for overall Korea in nearly 4 years. Already suffering due to the high stock of unsold apartments and the credit crunch, construction companies are clearly being hurt by the housing market downturn, with the number of construction company bankruptcies rising significantly over 2008.

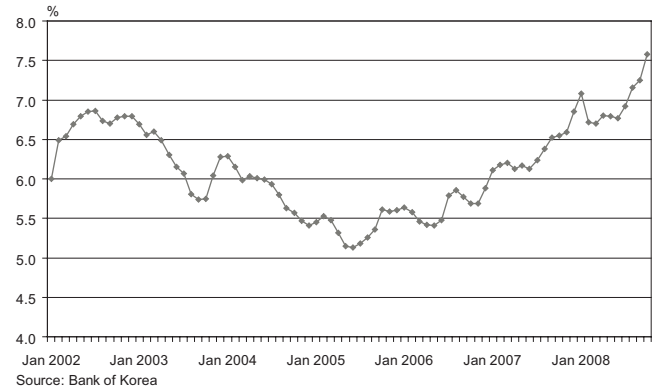
The government has pledged a number of policy changes aimed at 'revitalizing the real estate market'. To date, these have included buying up unsold properties from construction companies on repurchase agreements, reducing the number of areas designated as "speculation zones" (where stricter monitoring, leverage and selling conditions are imposed) and easing tax requirements on home owners. Although these actions may support the market to some extent, further declines in house prices are inevitable as the economy slows and credit conditions remain difficult. Indeed a nationwide decline in average house prices of 5 to 10 per cent over the next year cannot be ruled out. As already evident in the data, larger declines can be expected in regional areas where the supply overhang is most extreme and in areas where speculation-driven price increases were greatest over 2005 to 2007.

Medium-term Outlook

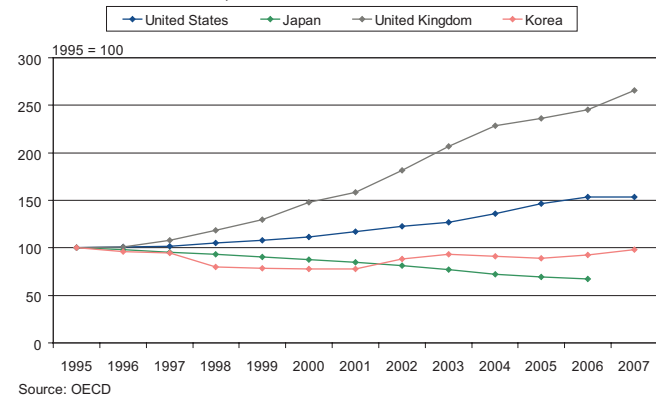
However, there are several reasons why we do not expect a downturn of the magnitude currently occurring in many other countries around the world. First, the increases in Korea's house prices have been far lower than what occurred in the US, Europe and other parts of Asia, where housing markets are now undergoing severe corrections. Inflation adjusted prices in Korea remain well below their level in the early 1990s, and recent IMF analysis suggests that average prices are lower than justified by fundamentals³. Second, Korea does not have the "subprime" mortgage related problems that have been especially problematic in the United States. Korean regulations require housing mortgage loan-to-value limits of between 40 and 60 per cent (depending on the house's location), one of the strictest limits of all OECD countries. Third, in the case of the SMA and some of the other metropolitan areas, persisting underlying supply shortages (as reflected in the number of households versus houses) will provide ongoing support to house prices. Any delays in new housing construction caused by the construction industry's current financial troubles will further exacerbate the current supply/demand imbalance into the medium term.

Assuming that market projections for economic recovery from the middle of 2009 eventuate, we expect house prices to bottom sometime in the second half of next year. Thereafter, the factors outlined above should support a sustained upturn in the residential real estate market.

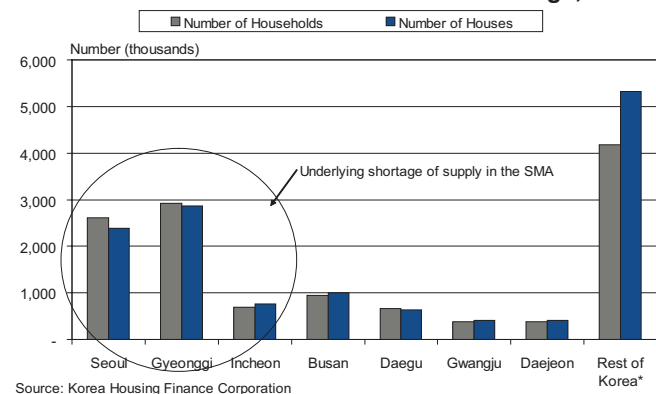
Average House Mortgage Interest Rate, January 2002 - October 2008



Real House Prices, 1995 - 2007



Estimated Number of Households and Dwellings, 2007



*The figure for "number of houses" is likely overstated due to the inclusion of abandoned dwellings.

² Approximately three quarters of these houses are not yet completed, but have entered the "pre-sale period", which usually begins 3 years prior to completion.

³ IMF World Economic Outlook, October 2008. The IMF's analysis involved comparing the movement of house prices with growth in per capita disposable income, working-age population, credit and equity prices, and the level of short-term and long-term interest rates.

