OPINION

Macro-Financial Analysis Division

Key Macroeconomic Issues for 2026

This article discusses the economic outlook for 2026, focusing on key issues including exchange rate conditions and assessment, as well as interest rate projections and associated risks. The Korean economy is projected to maintain a moderate recovery in 2026, with GDP growth of 2.0%. Consumer prices are expected to rise by 2.0%, remaining broadly stable. Bank of Korea is anticipated to maintain its policy rate at 2.5%, the estimated neutral rate.

Since the pandemic, the equilibrium level of the KRW/USD exchange rate appears to have shifted upward, and recently its divergence from movements in the U.S. dollar has widened. While the U.S. dollar index declined despite significant interest rate differentials, a combination of domestic structural and cyclical factors increased upward pressure on the won. However, cyclical pressures may gradually ease, supported by potential interest rate hikes by the Bank of Japan, moderation in the U.S. equity market rally, and Korea's inclusion in the world government bond index (WGBI).

Long-term interest rates (10-year government bond yields) in both the U.S. and Korea are expected to fluctuate around current levels. Nevertheless, considering upside risks to the U.S. term premium and domestic bond supply conditions, upward risks to Korea's term premium appear dominant. Under these conditions, attention should be paid to heightened rate volatility and the prolonged persistence of long-term rates in the 3% range. In particular, rapid increases in rates and volatility could generate instability through leveraged bond investments by private funds and potentially widen credit spreads.

Despite trade policy shocks originating in the United States, the global economy in 2025 performed better than expected. In the U.S., GDP contracted temporarily in Q1 2025 but

* All opinions expressed in this paper represent the author's personal views and thus should not be interpreted as Korea Capital Market Institute's official position.

rebounded sharply in Q2, returning to strong growth. Private consumption remained robust even after tariff shocks, while investment in AI-related technologies such as data centers expanded significantly, supporting growth. The euro area and China also showed stronger-than-anticipated growth.

In Korea, GDP declined by –0.2% quarter-on-quarter in Q1 2025 amid early-year slowdown but recovered thereafter, posting annual growth of 1.0% (preliminary). In Q3, private consumption and exports improved, and both manufacturing and services strengthened, resulting in a sharp quarter-on-quarter increase of 1.3%, contributing substantially to annual growth.[1)]

There is broad consensus among the market and major forecasting institutions that the Korean economy will sustain a moderate recovery in 2026. However, amid the persistence of a high KRW/USD exchange rate, diverse views exist among market participants regarding its prospects. In addition, Bank of Korea has recently adjusted its monetary policy stance[2)] in response to elevated exchange rate levels and financial stability risks. As a result, interest in the future path of market interest rates has increased. In light of these developments, this article examines the 2026 economic outlook, focusing in particular on exchange rate conditions and assessment, as well as market interest rate projections and associated risks as key issues.

Economic Outlook for 2026

Korea's GDP is projected to grow by 2.0% in 2026. Exports are expected to face limited momentum expansion amid sectoral divergence. Strong exports in shipbuilding and semiconductor-driven IT are likely to persist, while steel and petrochemicals may continue to struggle due to weak external demand. Domestic demand is projected to recover, driven by private consumption and construction investment. Improved income conditions and consumer sentiment are expected to support stronger consumption growth than in 2025. Construction investment, which declined for five consecutive years (2021–2025) and fell sharply by –9.9% in 2025, is expected to turn modestly positive, marking a meaningful improvement.

Consumer price inflation is forecast at 2.0% in 2026. Falling international commodity prices are expected to stabilize goods prices. The IEA projects continued oversupply in oil markets,

1) The negative quarter-on-quarter growth in Q4 2025 partly reflects a base effect resulting from the exceptionally strong growth recorded in Q3.

2) In its January 2026 statement, Bank of Korea removed language suggesting the possibility of further rate cuts.

implying lower crude prices. Major forecasting institutions[3] anticipate slight declines in most commodity prices excluding precious metals. These developments should partially offset upward inflationary pressure from the weak won. However, rising DRAM prices may affect prices of electronic products such as PCs and smartphones. Service prices are likely to continue upward trends, especially personal services sensitive to domestic demand, expected to rise around 3%.

Bank of Korea is expected to maintain its policy rate at 2.5% throughout 2026. The annual average nominal neutral rate for 2026 is estimated to be around 2.5%, and in consideration of the need to sustain the economic recovery while balancing exchange rate developments and financial stability risks, the bank is likely to keep the policy rate at the neutral level. In other words, under macroeconomic conditions in which inflation is aligned with the inflation target and growth is close to potential, monetary policy is expected to be conducted in a neutral manner. Although the domestic economy remains in the early stage of recovery—making it important to maintain growth momentum—concerns over housing price instability and the persistently high exchange rate remain elevated. Given these trade-offs, Bank of Korea is expected to hold the policy rate at its current level while monitoring economic conditions and the aforementioned risks, and to signal the future direction of policy rate adjustments in the second half of the year.

In the outlook for the domestic economy in 2026, the direction of global AI investment is expected to serve as both an upside and downside risk factor. Improvements in current account conditions with China stemming from better bilateral relations, the increasingly visible end of the Russia–Ukraine war, the wealth effect driven by a strong stock market, and strengthened consumer sentiment are considered upside factors.

On the other hand, uncertainty could be reintensified due to the expansion of U.S. trade policy uncertainty[4] following U.S. Supreme Court rulings. Additional downside risks that warrant consideration include geopolitical risks surrounding Iran and Greenland, as well as the possibility that a deepening K-shaped recovery in the domestic economy could negatively spill over into income and consumption conditions.

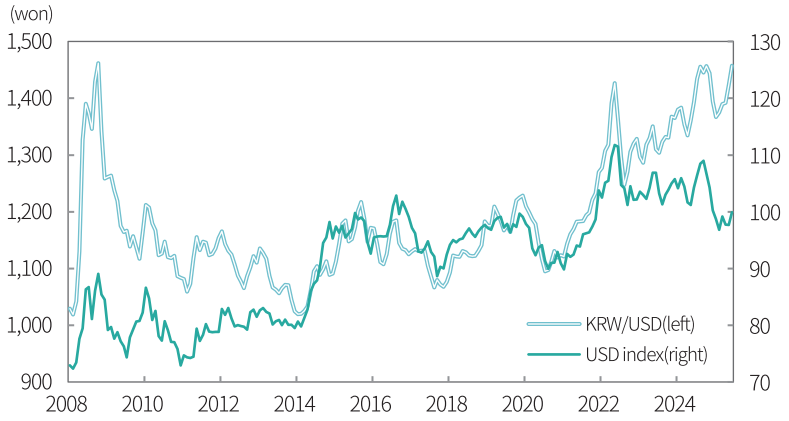
3) See, for example: World Bank, 2025, Commodity Markets Outlook; Goldman Sachs, 2026, 2026 Outlook: Ride the Power Race and Supply Waves.

4) Uncertainty also increased following President Trump's unexpected announcement (January 26, 2026) that a 25% tariff would be imposed on Korean exports. As the announcement was judged to be largely strategic rather than indicating immediate implementation, its impact was not reflected in this outlook.

Issue 1: Exchange Rate Conditions and Assessment

Since the second half of 2025, the KRW/USD exchange rate has remained elevated in the upper 1,400 won range, heightening concerns over import price pressures and external soundness. As exchange rate levels previously observed during financial crisis episodes have persisted for a considerable period, anxiety among economic agents has also intensified. Over the long term, the KRW/USD exchange rate has been primarily influenced by fluctuations in the U.S. dollar index. Prior to the COVID-19 pandemic, it fluctuated around an average of approximately 1,150 won in line with movements in the dollar index. During the sharp U.S. policy rate hikes in 2022, the dollar index surged, leading to a substantial increase in the KRW/USD rate. Recently, however, this relationship has clearly diverged. As shown in <Figure 1>, despite the sharp decline and subsequent stabilization of the dollar index since April 2025, the KRW/USD rate has risen steeply in the second half of the year, indicating a weakening comovement with the dollar.

Figure 1. Long-Term Trends in the KRW/USD Exchange Rate and the U.S dollar Index Since the Global Financial Crisis



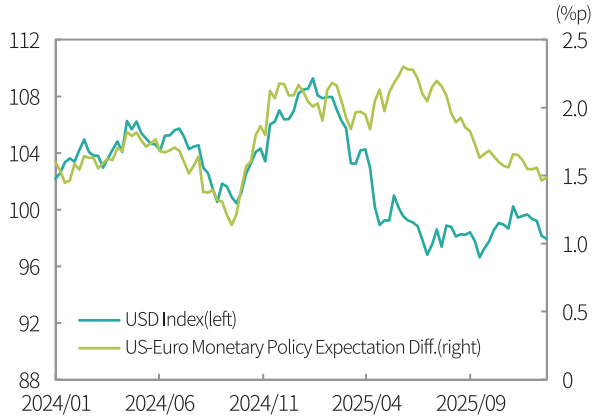
Note: Monthly average

Source: Refinitiv, Bank of Korea

According to textbook theory, the Trump administration's announcement of comprehensive tariff measures in April 2025 should have strengthened the dollar. Tariff imposition reduces imports, improves the current account balance, and increases demand for dollars. Moreover, in terms of interest rates, the monetary policy expectation differential between the United States and the euro area—which had driven dollar strength since the pandemic—remained significantly positive. Nevertheless, immediately after the tariff announcement, the dollar

depreciated sharply against major currencies. As illustrated in <Figure 2>, this shift becomes more evident when examining the relationship between the dollar index and monetary policy expectations. Prior to April 2025, the dollar index closely tracked the monetary policy expectation differential between the United States and the euro area (the one-year-ahead short-term rate differential between SOFR and ESTR). However, this relationship broke down following the April tariff shock. Although the expectation differential remained elevated at around 2 percentage points, the dollar index declined by 7 percent through end-June after the tariff announcement. Had the pre-April relationship persisted, the dollar index would have remained in the low-100 range by end-2025. Instead, given that it has fallen below 100, a substantial gap has emerged that cannot be explained by interest rate differentials alone.

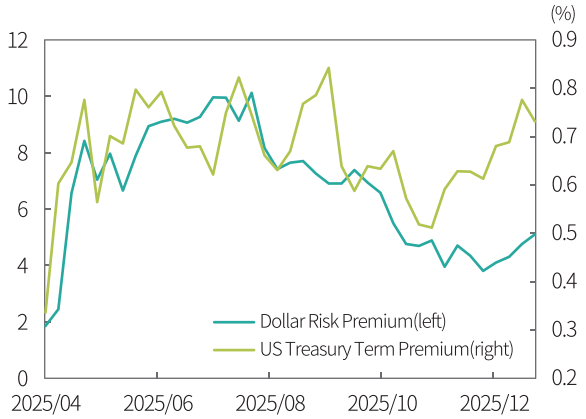
Figure 2. U.S. Dollar Index and Monetary Policy Expectation Differential



Note: The monetary policy expectation differential refers to the difference between the one-year-ahead short-term interest rate expectations (1Y×3M) for the United States (SOFR) and the euro area (ESTR).

Source: Refinitiv

Figure 3. U.S. Dollar Risk Premium



Note: The dollar risk premium is the residual from a regression (U.S. Dollar Index ~ monetary policy expectation differential) estimated using data prior to April 2025. The U.S. Treasury term premium is based on the estimates of Adrian et al. (2013).

Source: Refinitiv, KCMI

To quantify this gap, the pre-April 2025 data were used to estimate the normal relationship between the interest rate differential and the dollar index, which was then applied to the post-April period. The extent to which the actual dollar index fell below the level implied by the interest rate differential is defined as the “dollar risk premium.” This can be interpreted as the additional risk compensation investors demand for holding dollar-denominated assets, independent of interest rate attractiveness. Notably, as shown in <Figure 3>, the dollar risk

premium has begun to move closely in tandem with the U.S. Treasury 10-year term premium.[5] From February to December 2025, both variables rose together from April onward and have remained elevated. As the U.S. Treasury term premium increased from 0.3% to 0.8%, the dollar risk premium rose in parallel.[6] This suggests that investors have begun to require additional compensation for holding U.S. assets per se.[7] Although the divergence between the interest rate differential and the dollar index appears to narrow again in the second half of 2025, closer examination reveals that the convergence occurred not because the dollar rebounded toward the interest rate differential, but because the differential itself declined toward the dollar index. This reflects not a "dissipation of the shock," but rather an "adjustment toward a new equilibrium."

Such structural changes in the global dollar market have directly affected the KRW/USD exchange rate. In the past, the direction of the KRW/USD rate could be forecast to some extent based on prospects for the dollar index (a global factor). Since the second half of 2025, however, Korea-specific factors have gained significantly in influence. Structurally, the expansion of overseas asset allocation by the National Pension Service (NPS) and other institutional investors has exerted depreciation pressure on the won. As domestic savings expand due to population aging while growth momentum weakens and investment opportunities remain constrained, residents' preference for foreign assets has strengthened. This structurally increases demand for dollars in the foreign exchange market. Since 2018, residents' overseas equity investment has generally exceeded USD 20 billion annually, suggesting not a temporary concentration but an ongoing medium- to long-term portfolio reallocation toward a higher share of foreign assets (Kang, 2025).[8]

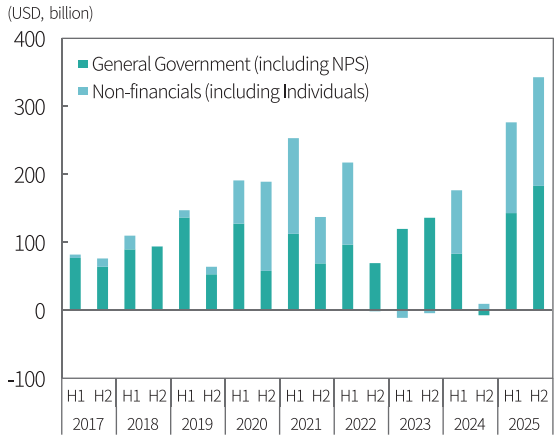
5) The term premium refers to the additional compensation investors require for holding long-term bonds and corresponds to the difference between long-term government bond yields and the expected path of monetary policy. For further details, see: Adrian, T., Crump, R.K., Moench, E. (2013), Pricing the Term Structure with Linear Regressions, *Journal of Financial Economics*, 110(1).

6) Regression analysis of the dollar risk premium on the U.S. term premium shows that the coefficient after April more than doubled compared to the pre-April period.

7) Jiang et al. (2021) point out that if convenience yield is not explicitly incorporated into term structure models, the estimated term premium may reflect a mixture of the pure term premium and the convenience yield (Jiang, Z., Krishnamurthy, A., Lustig, H. 2021, Foreign Safe Asset Demand and the Dollar Exchange Rate, *Journal of Finance*, 76).

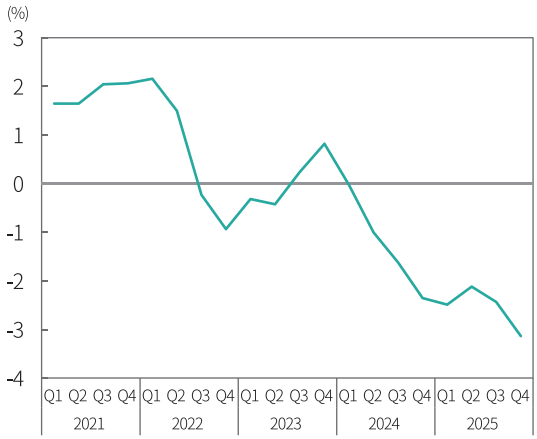
8) Kang, Hyunju, 2025, Background of Recent Won Depreciation and Its Macroeconomic Implications, Capital Market Focus 2025-26, Korea Capital Market Institute.

Figure 4. Residents' Investment in Foreign Equities



Note: For 2025, figures cover January–November.
Source: Bank of Korea

Figure 5. Deviation of the Real Effective Exchange Rate



Note: 1) The small open economy model of Berger & Kempa (2014) is estimated using Korean data.
2) The more negative the value, the greater the undervaluation of the Korean won.
Source: KCMI

However, recent exchange rate increases cannot be fully explained by structural factors alone. Cyclical factors—including retail investors' surge in U.S. equity investment related to AI themes, concerns over increased outward direct investment to the United States amid tariff negotiations, and won–yen co-movement—have amplified upward pressure in the short term. Notably, even during periods in 2025 when the dollar index declined, the KRW/USD rate continued to face upward pressure in tandem with the JPY/USD rate. As issues commonly faced by Korea and Japan—such as strengthened U.S. protectionism and pressure for investment in the United States—came to the fore, market participants began to perceive both currencies as exposed to similar external risks. Consequently, the JPY/USD rate has functioned as an important reference rate for the KRW/USD rate, creating a transmission channel through which yen depreciation driven by Japan-specific factors spills over to the won.[9] This dynamic, combined with increased investment in U.S. equities amid the AI investment boom, further heightened short-term upward pressure on the exchange rate. In other words, within a structural trend of rising demand for overseas securities investment, shifts in risk appetite and exchange rate expectations can accelerate capital outflows at certain junctures, increasing

9) The daily correlation between the JPY/USD and USD/KRW exchange rates rose significantly from 0.62 in the first half of 2025 to 0.96 in the second half.

volatility. Indeed, as shown in <Figure 4>, overseas equity investment by retail investors—after a period of deceleration—expanded to more than three times its 2024 level in 2025, and the resulting increase in dollar demand supported exchange rate depreciation. Taken together, these factors suggest that the degree of undervaluation of the won relative to its equilibrium real effective exchange rate[10] has widened (see <Figure 5>).

Fortunately, cyclical factors may gradually ease. If the Bank of Japan raises interest rates and induces yen appreciation, downward pressure on the won could diminish. A slowdown in the U.S. equity market rally could also temper retail investors' enthusiasm for overseas investment. Korea's inclusion in the WGBI may facilitate foreign capital inflows into the domestic bond market, and an anticipated recovery in the domestic economy could improve confidence in the won. In particular, given that the won appears undervalued relative to economic fundamentals, exchange rate stabilization is possible if cyclical pressures subside. However, as overseas investment expansion by pension funds and other institutional investors forms part of a long-term portfolio diversification strategy, the structural component of foreign exchange demand and supply is unlikely to reverse in the short term. Accordingly, the future path of the KRW/USD exchange rate is likely to evolve on a structurally higher base level determined by structural factors, with cyclical elements—such as interest rate expectations, risk appetite, and yen co-movement—driving volatility around that level.

Issue 2: Interest Rate Outlook and Risk Factors

This section aims to forecast long-term government bond yields (10-year) in the United States and Korea and to examine the associated risk factors. Government bond yields consist of the "risk-neutral rate," which reflects expectations regarding the future path of short-term interest rates, and the "term premium," which compensates investors for bearing interest rate risk over the life of the bond.[11] Below, based on the ACM model[12], we decompose these two components to project long-term government bond yields in the United States and Korea.

First, an analysis of the U.S. 10-year Treasury yield by decomposing it into the risk-neutral rate and the term premium (<Figure 6>) suggests that the 10-year yield is expected to fluctuate

10) Estimated using the methodology of: Berger, T., Kempa, B. (2014), Time-varying Equilibrium Rates in Small Open Economies: Evidence for Canada, *Journal of Macroeconomics*, 39(A).

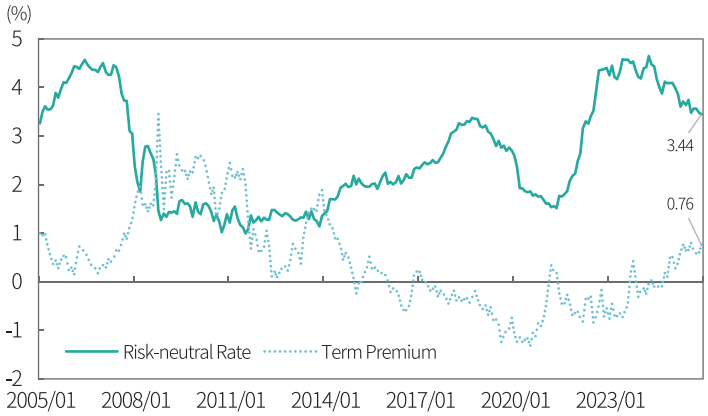
11) KCMI Macro-Financial Analysis Division, 2024, Key Macroeconomic Issues for 2024, Capital Market Focus 2024-03.

12) Based on the model of Adrian et al. (2013).

around its current level of approximately 4% during 2026. With respect to the risk-neutral rate, the nominal equilibrium rate[13] implied in current U.S. Treasury yields is close to the mid-3% range, which corresponds to estimates of the nominal equilibrium rate[14] derived from macroeconomic fundamentals. In addition, expectations of one policy rate cut[15] by year-end are already reflected, consistent with the outlook for monetary policy.[16] Considering these factors, the 10-year risk-neutral rate is expected to remain broadly stable at its current level.

The term premium on U.S. Treasuries[17] is also projected to remain near its recent level. Although volatility may increase temporarily due to issues such as Federal Reserve personnel matters, it is expected to stabilize gradually. While uncertainties surrounding employment, inflation, and the fiscal deficit persist, these risks appear to be largely priced in at current levels, suggesting limited additional impact. However, from a risk perspective, upside risks to the term premium predominate, warranting caution regarding the potential for higher interest rates.

Figure 6. Decomposition of the U.S. 10-Year Treasury Yield



Note: Decomposition based on the ACM term structure model

Source: Federal Reserve Bank of New York

In 2026, Korea's domestic market interest rate (10-year government bond yield) is expected to fluctuate around its current level. As shown in <Figure 7>, the risk-adjusted yield indicates

13) The 5Y×5Y forward rate derived from the risk-adjusted rate is used as an indicator of the long-term nominal equilibrium rate.

14) Kang, Hyunju & Baek, Inseok, 2024, Assessment of the Possibility of Returning to a Low-Interest-Rate Environment Following Monetary Policy Transition, KCMI Issue Report 24-07.

15) The 1Y×1Y forward rate derived from the risk-adjusted rate, reflecting market expectations of the short-term monetary policy path.

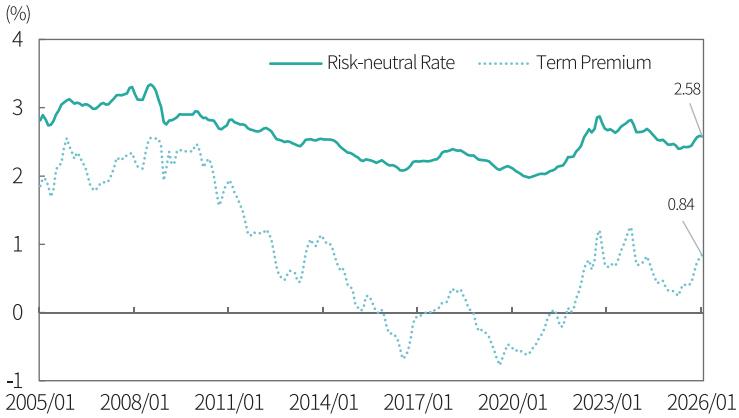
16) At the KCMI seminar "Capital Market Outlook and Key Issues for 2026," one Federal Reserve rate cut during 2026 was projected.

17) The term premium is influenced by inflation uncertainty, government bond supply-demand conditions, and monetary policy uncertainty (KCMI Macro-Financial Analysis Division, 2024).

that the nominal equilibrium interest rate embedded in domestic government bond yields is close to the estimated nominal equilibrium rate of 2.5% derived from macroeconomic fundamentals. The market appears to be pricing in either a policy rate hold through year-end or the possibility of one rate hike, which is broadly consistent with the monetary policy outlook presented in the previous section (2026 policy rate: 2.5%). Accordingly, the 10-year risk-adjusted yield is expected to remain at its current level for the time being.

In addition, the term premium is projected to remain at its recent level. While inclusion in the WGBI serves as a downward pressure factor, it is likely to be offset by upward pressure stemming from domestic bond supply (increased issuance of government and government-guaranteed bonds[18]). However, from a risk perspective, upside risks to the domestic term premium are dominant, particularly due to the possibility[19] of a rise in the U.S. term premium, warranting caution regarding potential increases in interest rates.

Figure 7. Decomposition of the 10-Year Korean Treasury Bond Yield



Note: Decomposition based on the ACM term structure model

Source: Bloomberg, KCMI

Domestic interest rates entered an upward trend in the second half of 2025. As long-term rates in the 3% range are likely to persist and volatility may further increase, their impact warrants close examination. First, in terms of the effects of interest rate fluctuations, it is necessary to monitor the inter-institutional repurchase agreement (Repo) market. Recently, in the bond market, leveraged investment—primarily by private funds—has expanded significantly,

18) Invest Chosun (January 15, 2026), "Government-Guaranteed Bond Issuance to Reach KRW 25 Trillion This Year… Ministry of Economy and Finance Begins 'Pre-coordination' of Bond Issuance."

19) The domestic term premium is found to be influenced by the U.S. term premium (KCMI Macro-Financial Analysis Division, 2024).

with funds being raised through Repo and reinvested in bonds. As shown in <Figure 8>, the volume of Repo by asset managers and securities firms has continued to increase, and leveraged investments by private funds are estimated to amount to approximately KRW 100 trillion.[20] If interest rates rise, bond prices will decline, amplifying losses on leveraged investments by private funds and potentially heightening instability in the Repo market, which serves as their primary funding channel. Accordingly, it should be noted that sharp increases in interest rates and heightened volatility could raise risks in the Repo market through the aforementioned transmission channels.

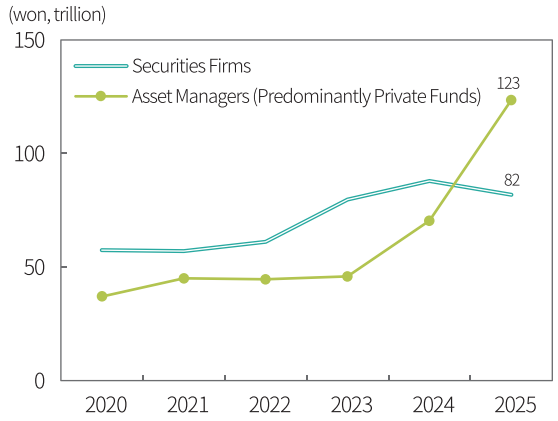
In addition, it is necessary to assess the potential widening of credit spreads.[21] As shown in <Figure 9>, during periods when the yield on 10-year Korean Treasury bonds rises, credit spreads tend to increase as well. Although credit spreads have not yet reached elevated levels compared to the past[22], they did rise in tandem with the increase in 10-year Treasury (KTB) yields in the second half of 2025. In 2026, issuance of corporate bonds and government-guaranteed bonds is expected to increase, and the resulting supply pressures in the credit bond market may exert downward pressure on corporate bond prices—that is, upward pressure on credit spreads. An increase in credit spreads would add to the burden on the real economy and negatively affect the securities industry, which relies on market-based funding. Therefore, careful attention should be paid to the possibility that credit spreads may widen as government bond yields rise or remain elevated for a prolonged period.

20) The average daily balance of asset managers' repo (sales) in 2025 stood at approximately KRW 123 trillion, most of which is estimated to be attributable to private funds.

21) The credit spread is defined as the difference between the yield on one-year A-rated corporate bonds and one-year government bonds.

22) As of January 2026, the average credit spread was 1.1%, lower than the three-year average (2023–2025) of 1.24%.

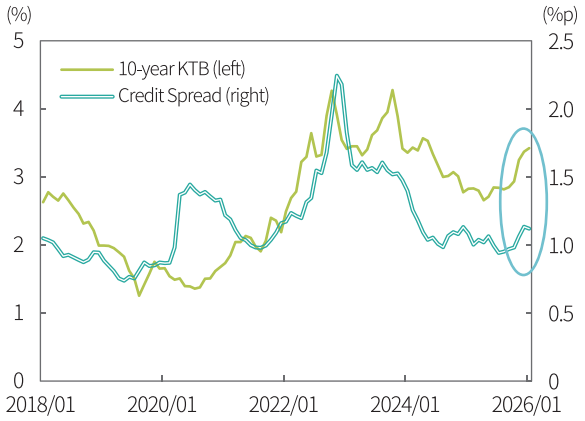
Figure 8. Repo Volume of Asset Managers and Securities Firms



Note: Annual average daily outstanding balance of Repo sales

Source: Korea Securities Depository

Figure 9. Government Bond Yields and Credit Spreads



Note: The credit spread refers to the difference between one-year maturity A-rated (A-) corporate bonds and government bonds.

Source: Korea Financial Investment Association Bond Information Center

Conclusion

The domestic economy is projected to maintain a moderate growth trajectory in 2026. With generally stable inflation conditions expected to persist, Bank of Korea is anticipated to keep the policy rate at a neutral level, taking into account the balance among economic conditions, the exchange rate, and financial stability risks. The KRW/USD exchange rate is projected to gradually decline as cyclical upward pressures ease, while U.S. and domestic market interest rates are likely to fluctuate around their current levels. However, given the presence of potential risk factors—including increased leverage in bond investments and upward pressure on credit spreads—it is necessary to closely monitor these risks and strive to maintain financial market stability.