Republic of Korea

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS **June 18, 2013**

Analyst: Rolf Danielsen. Tel : +46 8 7638392. E-mail: rolf.danielsen@seb.se

The slowdown that started in 2012 continues in 2013 marking an unusual two years sequence of a soft patch with growing dependence on the global economy to pull it up in 2014. That may also hinge on its two neighbours' ability to maintain steady growth and calm in relations with Pyongyang.

Country Risk Analysis

Summary

Current economic performance below expectations. Following a decent recovery after the global financial crisis in 2009, growth began to sputter in 2012 ending the year at an unusual weak 1,5% yoy (year-on-year) growth in the fourth quarter. That was much due to rising global uncertainties, in particular the intensification of the euro-crisis, with repercussions on domestic investment sentiment but also cooling of the housing market as households began to worry over high debt levels. In return, slowing domestic demand helped curb imports to keep the trade and current account balances in healthy surpluses around 3% of GDP. That was supported by an undervalued exchange rate enabling maintain reserves at 11 months of import cover.

Overall well-managed macro policies: WellDespite 2012 being an important election year, the fiscal stance remained overall neutral while accommodative monetary policies continued with two rate cuts in face of weakening price pressure and slowing credit growth from banks. The latter is now given a relative clean sheet of health from IMF and others despite some continued vulnerability to wholesale funding from abroad, including from European banks. By contrast, concerns are rising about the growing shadow banks industry.

Orderly domestic policies contrast with external security threats: The orderly re-election of the incumbent Saenury party (centre-right) under a new president, Ms. Park, has burnished South Koreas democratic credentials. The threat from North Korea, in contrast, is a constant source of concern. While the calm leadership succession in Pyongyang late 2011 raised hopes for an improvement, recent developments have reignited fears that event-risk cannot be ignored. Chinese control, however, with Pyongyang continues as the ultimate arbiter by all appearances.

Rating upgrades: In the recent 12-month period, two rating agencies have upgraded Korea based on impressions of strengthened resilience and expectations of near term economic recovery while pointing to some signs of improvements in relations to the North. While not taking direct issue with any of these points we believe recent developments including in Japan and China give reason for some caution.

Recent developments

The marked slowing of the economy in 2012 and early 2013 is testament to the vulnerability to global headwinds through trade, investment and sentiment channels. At the same time the cyclical softening of the domestic housing market has caught many households reconsidering their present high leverage levels.

The economy reacts to global headwinds: Having staged a decent recovery after the global financial crisis in 2009, during which Korea avoided an outright recession on an annual basis, the economy began to stutter in early 2012. That reduced growth to 2,6% in the first half of the year and only 1,5% in the rest of the year with an average of only 2% against 3,8% in 2011. Clearly weaker investments in machinery and equipment led the downturn as signals of continued euro troubles and potential budget problems in the US hit investor sentiment included in the powerful export industries. As a result, growth of investment demand, including construction, turned south to the tuned of a 2% annual reduction. Notwithstanding steady real wage growth, consumer demand also softened but maintained at least a positive real growth rate of 1,7%. On the external side, exports still managed 3,8% real expansion despite poorer global prospects while import growth fell to only 1,5%. That left net exports the only major impetus to growth. 2013 has so far presented a mixed bag but 0,9% growth qoq (quarter-on-quarter) in January-March surprised on the upside. Weak order books nevertheless indicate continued problems leaving the central bank to expect less than 2% growth in the first half of the current year.

Inflation falling along with reduced unemployment. To little surprise against a background of weaker activity, consumer price inflation has abated to only 1% year-on-year (yoy) in last May from 2,5% 12 months earlier. Both were clearly below the central bank's policy target of 3%. That was much due to stagnant import prices of energy and reduced administered prices, including for child care. Those items are excluded from the measure of core inflation that ended higher at 1,5% in last May. Despite signs of tapering demand pressure unemployment has continued to edge lower to 3,2% at the beginning of 2013, masking, however, high youth unemployment at more than 8% for the age group 15-29. That kept up the pressure on wages which rose by an average of 5% in 2012, in part the footprint of an ageing and stagnant labour force.

The external sector remains overall healthy. While export growth halved from the year before, imports came almost to a halt. As a result, the current account and trade balances both ended in healthy surpluses in line with recent years' experience of around 3% of GDP. While exports to Europe and Latin America struggled, dipping by a third in case of the latter, shipments to China and other emerging Asian countries continued at a healthy pace of respectively 16% and 8% increases in particular of IT products. On the capital account, erstwhile concerns of a heavy repayment schedule for external debt in 2012 and 2013 mainly related to corporates and banks have so far proved unfounded. Last year, almost $70bn. of loans were repaid or rolled over on a timely basis and a similar amount scheduled for this year is not expected to cause more trouble. That is in part helped by strong capital inflows mostly into the stock market while inflows of foreign direct investments (FDI) have as in previous years been almost offset by FDI outflows of the same magnitude. In the end, reserves ended slightly up and as such maintained import coverage at more than 11 months considered as more than satisfactory given the country's floating exchange rate management.

External debt at 40% of GDP. At the end of 2012 external debt had increased to $415 bn. or around 40% of GDP. That number exceeds official reserves by a wide margin but is mitigated by lengthened maturity as the share of short term debt has dropped to a third from almost a half only five years ago.

Policies:

While the fiscal stance has remained overall neutral, even accounting for two minor stimulus packages, monetary policies have continued along an accommodative path. Structural policies related to the state owned enterprise sector appear on hold.

Fiscal policies on an even keel: The government budget in 2012 ended with a reduced surplus of 0,4% of GDP, down from 1,5% the year before, as weaker activity slowed the tax take and as the government in 2012 introduced a supplementary budget with a direct impact of some 0,5% of GDP. (The government presented the stimulus as much larger, but most of that was accounted for by automatic stabilizers.) The budget for 2013 will probably show continued weakness, turning the balance into a into deficit of around half a percent of GDP after the government presented a new minor stimulus package in last April. This deterioration has yet to cause concerns among market participants and observers.

Government debt and state owned enterprises: Direct government debt remains moderate at around 34% of GDP with a reasonable maturity structure and of which less than a sixth was held by foreigners as of early 2012. That said, markets may at some point in the future turn focus on contingent liabilities to the sovereign, including the growing debt burden of the seven major state owned enterprises. This debt exceeds 25% of GDP, having grown rapidly from 15% in 2006. Most of it is held by profitable and well-capitalized enterprises, but administrative interference with public utility pricing is worsening the finances of some of them including the largest power company.

Monetary policy easing: Since early 2012 Bank of Korea (central bank – BOK) has lowered is policy rate three times, by a total of 75 bsp. in line with abating consumer price pressure in line with the bank's mandate to target CPI inflation at around 3% pa with a new margin narrowed to +/- 0,5 percentage points. It may also have been motivated to support the government's fiscal stimuli measures in particular against the background of flagging credit growth. That shrunk to 5% in 2012 from almost 9% the year before mainly in response to the cooling of the corporate credit demand. Mortgage demand, in contrast, continued quite strong through most of the year but also cooled after tax incentives for house purchases expired in September. By the same token. BOK also raised the ceilings for aggregate annual credit growth by 1,5 trillion won and provided extra liquidity to the market through the year.

Overall sound banking system but shadow banks present a concern: Since the Asian crisis in 1998 Korean banks have been thoroughly restructured and recently also reduced their dependence on foreign capital. The level of non-performing loans (NPL) is down to an average of 1,5% among regular banks and their risk weighted capital ratio is at a solid 14%, clearly above internationally recommended minimum. That said, however, it should also be noted that the financial system includes a host of smaller financial institutions, often referred to as shadow banks - which in total represent almost a third of total credit intermediation and has seen a growing market share over recent years. Some of them have recently been in trouble and last year the authorities closed several of them. Many shadow banks are increasingly involved in household financing as regular banks have grown more cautious toward this market segment. Households remain leveraged to the tune of 150% of GDP. That is not excessive if compared with Europe and the US but doubts are that household financing may present less of a mature market in Korea. In return, it is noted that regular banks are under tight supervision and with a loan to value of maximum 50% on mortgages they should be in a position to meet even a serious downturn in the housing market.

The housing market cools off: Following two years of rapid price appreciation, the housing market peaked in late 2012 and appears to have levelled off so far in 2013. In the trend setting Seoul area including Gangnam there has even been signs of price drops. In early 2013, this prompted the government to announce new tax incentives for first time buyers and also easing of credit conditions to help developers reduce an overhang of unsold units. Avoiding the housing market turn into a rout is also important to keep up consumer sentiment.

Outlook

Reduced expectations of near term growth: Since the beginning of the current year the authorities have moderated expectations of short to medium term economic growth to 2,6% in 2013 and 3,8% in 2014. That is in spite of some upbeat signals including improving business sentiment for manufacturing over four consecutive months until April and a surprisingly strong 0,9% quarterly growth in Q1. However, credit conditions remain soft, and industrial production was still falling in the first three months of the year. Global developments have not presented much ground for optimism and our own assessment is that the authorities maybe erring on the side of optimism. Without an unexpected turn around in Europe and with rising uncertainty regarding medium term prospects of Korea's two big neighbours, China and Japan, growth might rather fall within a 2-3% range.

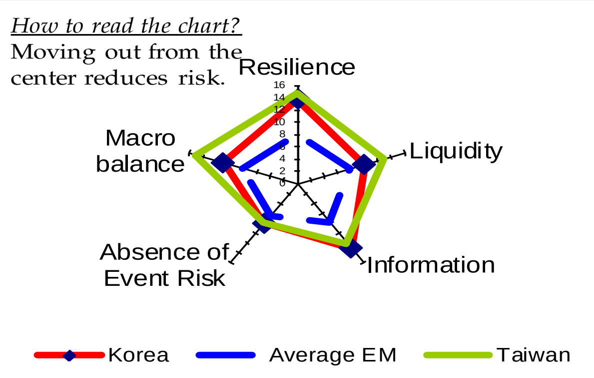
But the country is likely well prepared for it: That is unlikely to spell disaster for a country with such strong external and internal balances as Korea. It has nevertheless prompted some observers, including the Institute of International Finance (Washington DC), to question if the country could be on the brink of deflationary weakness.

The threat that won't go away: While we still believe in the country's resilience and ability to adjust to changing global and regional winds, including on the basis of a quite well-diversified industrial structure, external security could still present a tail-risk event. The long-standing issue of North Korea have a tendency to come back every time observers thought they had seen a light in the tunnel. Last year, the regime in Pyongyang defiantly conducted both nuclear and missile tests and continued with bellicose language after having been punished by UN sanctions of last February, this time also supported by China. The regime followed up by closing the Kaesong joint North-South Industrial Zone and terminating the armistice agreement from the Korea War in the early 1950s.

But is still under reasonable control: Ultimately, however, the regime did not act on threats of new strategic weapons tests. Moreover, after the US Foreign Secretary had made an impromptu visit to Beijing, North Korean rhetoric moderated. It appears that the regime has recently agreed to new negotiations including with the US. That may present some assurances that the regime is still willing to listen and its room for action is limited by Beijing. At the moment, however, the situation is still hard to predict. The CDS market has reacted to recent events with increased volatility.

Key ratios	**2012**
Population (mill.)	48.8
GDP/capita ($)	23 145
GDP(% change)	2.0%
Inflation	2.2%
Curr.Acc. Balance/GDP	3.9%
Reserves/imports (months)	11
Budget balance/GDP	1.5%
Government net debt/GDP	46%

External ratings:	**Peers:**
Fitch: A+ (pos) S&P: A Moody's: A1 (pos)	Poland China Taiwan



Graph: Korea's risk profile is stronger on resilience and liquidity than the average for all emerging market countries. However it is weighed down by event risk, much like its peer Taiwan.

Key data:	2008	2009	2010	2011	2012	2013	2014	2015
GDP (bill. US$)	951	840	1015	1115	1130	1189	1275	1357
GDP/capita (US$)	19747	17363	20917	22908	23145	24292	25979	27596
GDP (change)	2.3%	0.3%	6.3%	3.7%	2.0%	2.1%	2.8%	3.2%
Investments/GDP	27%	27%	26%	25%	24%	24%	25%	25%
Budget balance/GDP	1.5%	-1.7%	1.4%	1.5%	1.5%	-0.5%	-0.2%	-0.2%
Govt debt/GDP	34%	40%	42%	43%	46%	48%	50%	52%
CPI inflation (%)	4.7%	2.8%	2.9%	4.0%	2.2%	1.5%	2.5%	2.7%
Money demand (%)	13%	11%	8%	4%	6%	6%	9%	9%
Stock prices (%change)	1534	1425	1762	1985				
Interest rates	5.5%	2.6%	2.7%	3.4%	3.3%	2.7%	3.0%	4.0%
Exch. Rate ($)	1100	1277	1156	1108	1127	1104	1091	1091
Trade/GDP (%)	99%	101%	100%	106%	106%	103%	107%	113%
Oil price (Brent)	$97	$62	$80	$111	$112	$105	$106	$112
Billions US $								
Export of goods	472	449	529	608	623	632	696	775
Imports of goods	466	403	485	574	579	588	666	754
Other:	-1	-14	-17	-8	0	1	0	-2
Current account	**5**	**31**	**27**	**25**	**44**	**45**	**29**	**20**
as % of GDP	0.5%	3.7%	2.7%	2.3%	3.9%	3.8%	2.3%	1.5%
FDI (in)	-17	-15	-22	-16	-19	-19	-21	-22
Loan repayments (MUSI	-95	-81	-86	-87	-85	-79	-78	-78
Net other capital flows (I	95	62	120	97	74	64	82	93
Balance of payments	**-13**	**-3**	**40**	**19**	**14**	**11**	**12**	**12**
Reserves	240	238	277	297	310	321	333	345
Total debt	352	329	360	394	415	409	408	408
o/w short term debt	173	147	150	146	134	121	120	120
Rating history								
Fitch (eoy)	A+	A+	A+	A+				
Moodys	A2	A2	A2	A1				

Type of government:

Next elections Presidential: 2017 Legislative: 2016

Other:

Latest PC deal None

Latest IMF arrangement: Stand-by 1997

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