Republic of Korea

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Despite a boost from expansionary policies, economic growth has slowed on the back of a poor export performance. At the same time, external balances have improved further. Prospects for the implementation of structural reforms in the near-term have faded.

Country Risk Analysis

Summary and conclusions

Korea's economic growth slowed to 2.5% in 2015 from 3.3% with weak external demand and the MERS outbreak weighing heavily on activity. Policy stimulus from both the monetary and fiscal fronts supported domestic demand, thereby dampening the downturn.

Developments on the external side have been encouraging with the current account having been in surplus every year since the Asian financial crisis. It rose to a new record high in 2015. The unbroken years' of surpluses have helped lift the country's net international investment position into positive territory and reduced one of the economy's past vulnerabilities.

Government finances are healthy leaving room for more fiscal stimulus in the near-term. Government debt as a share of GDP is on an upward trend but is still broadly in line with that of rating peers. Following parliamentary elections in April 2016, the conservative Saenuri party failed to keep its small parliamentary majority. This has produced some uncertainty on the direction of economic policy. While structural reforms, in particular relating to the labour market, appear to be losing some momentum, the ongoing corporate restructuring processes should reduce structural problems and risks in the economy in the medium term. At the same time it could magnify downside risks to economic growth in the short term.

Moody's and Standard&Poor's upgraded their sovereign ratings one notch in late 2015 commenting that Korea's credit metrics are expected to remain strong, economic growth to remain superior and that very high institutional strength will support continued structural reform. While largely sharing most of their reasoning, we would argue that the government's recent loss of majority in parliament reduces the likelihood that their structural reform agenda will be implemented.

North Korea remains a constant source of concern, both from a security point of view and from the costs to the South associated with a possible collapse of the regime. Meanwhile, the broader geopolitical tensions in East Asia remain significant.

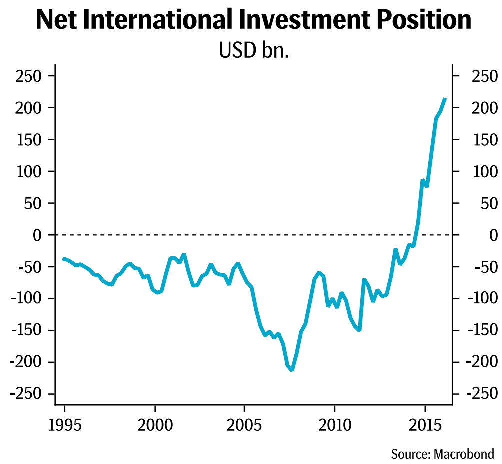
Recent economic developments

Economic growth has slowed. The slowdown in global trade has hit Korea hard, as exports make up nearly 60% of total demand in the economy. Average GDP growth rates have declined from over 4% in 2001-2011 to under 3% since 2011. Last year, the economy was hit not only by weak demand in China and other important export markets but also by the outbreak of the Middle East Respiratory Syndrome (MERS), which led to a sharp contraction of household spending in the second quarter. Despite some recovery in the second half of the year, thanks to expansionary economic policies, economic growth slowed to 2.6% in 2015. While this is low compared to Korean historical standards, it is well in line with rating peers.

The weak export performance has continued into 2016 and appears to be spilling over on the domestic sector too. Exports to China and Japan have been falling roughly 10% in annual terms recently. Overall GDP growth in the first quarter cooled to 2.8%.

Low but rising inflation: As growth fell below potential rates and oil prices fell, inflation was subdued at 0.7% in 2015. Core inflation that excludes energy and food rose slightly however. In 2016, inflation has been hovering just below 1%, well below the central bank's inflation target.

External position has turned into strength: Korea's current account has been in surplus every year since the Asian financial crisis. Last year it rose to a record high USD 106 bn or 7.8% of GDP, despite a hefty fall in the surplus with China, partly due to import compression. This has contributed to lifting the net international investment position (the balance between the economy's foreign assets and liabilities) into positive territory and reducing one of the past vulnerabilities of the country.



Despite a solid surplus in Korea's current account, FX interventions by the central bank have worked in the opposing direction producing a broadly stable level of official foreign reserves in the past year. At the current level, Korea maintains import coverage of about 9 months which should be considered as more than satisfactory given the country's floating exchange rate management.

External debt declined in 2015: At the end of 2015 the country's external debt had decreased and was equivalent to around 30% of GDP. The share of short term debt dropped to about a quarter mainly due to a decline in banks' short term debt.

Policies

Fiscal policy has been expansionary. The government increased spending significantly in 2015 to support the economy. Several stimulus packages and cuts in consumption taxes pushed the general budget balance just below zero if the social security funds are included (as done by the OECD and the IMF). Most observers expect a very marginal deterioration in the balances for 2016. In early 2016, the government announced new measures to boost economic growth, including the front loading of public spending. More stimulus measures are expected in a supplementary budget due shortly. Given the solid starting position for government finances, this would seem appropriate.

Government debt is moderate. Direct government debt remains moderate at around 35% of GDP with a reasonable and gradually improving maturity structure. The debt is on a steady upward trajectory, however, with the government estimating that it will breach 40% of GDP in 2016. Including also the debt of the state-owned enterprises, which constitute a contingent liability, yielded a consolidated debt of 64.5% in 2014 (the most recent data). On top of this we would note that additional contingent liabilities to the government could stem from the extensive lending of the policy banks.

Monetary policy turned more accommodative. With inflation below the target of 2.5-3.5 for an extended period, the central bank initiated a series of rate cuts last summer. At the same time, the inflation target was changed to 2% for 2016-2018 which is more in line with central banks in other advanced economies. Elevated levels of household debt were one of the main reasons for a reluctance to cut rates further. However, in June 2016 the policy rate was reduced to record low 1.25%. In addition, a controversial proposal for the central bank to embark on a form of quantitative easing, mainly aimed at facilitating the restructuring of corporate debt in the shipping industry, now appears to have been given a green light.

Household debt is high and gradually rising. Household debt rose in 2015 reaching nearly 90% of GDP or about 167% of disposable income, and continued up in the first quarter of 2016. While it may be disputed what level of debt is too high, we note that these levels are higher than in most peer economies. They are also higher than in many advanced economies.

The main risk stemming from high indebtedness is growth related as household spending may be stifled once interest rates start to rise. With consumption making up around half of GDP this would pose a risk to overall economic growth. However, in a worst case scenario, household indebtedness is also a financial stability risk as households' inability to repay their credits could lead to a rise in banks' non-performing loans. A mitigating factor is the fact that average household assets are nearly five times larger than debt per household. Nevertheless, in 2015 the government started taking measures to halt the continued build-up of debt. These include incentives for choosing fixed rate and amortising loans rather than floating rate loans which dominate.

Measures taken to facilitate corporate restructuring. Corporate debt in Korea at 106% of GDP is also high compared to peers. In the second half of 2015, the government stepped up efforts to facilitate the restructuring of many corporates suffering from high debt and excess capacity. In particular this relates to the shipping and shipbuilding industries that are making large losses and see falling orders following the global economic slowdown. More recently, the government together with the central bank decided to set up a temporary fund of about USD 9.5 bn. to support the restructuring of companies in these sectors. The ongoing restructuring processes may reduce structural problems and risks in the economy in the medium term but could magnify downside risks to economic growth in the short term.

Generally sound banking system. The banking sector in Korea is large with total assets amounting to more than three times GDP at end-2012. Vulnerabilities have decreased considerably since the 2008 crisis as banks have improved solvency and liquidity and short-term external debt has declined steadily. Non-performing loans as a share of total loans remain very low. Profitability, however, is also low, particularly among the state-owned banks, and capital adequacy ratios are among the lowest in the OECD although still well above the 8% BIS standard.

External sovereign rating upgrade. Standard&Poor's (S&P) and Moody's upgraded their sovereign ratings one notch in late 2015. S&P mainly argued that economic growth will remain superior to most developed economies and risks to external finances had declined. Meanwhile, Moody's stressed, first, in their view, Korea's credit metrics will remain strong and resilient despite continued weak global demand. Second, that very high institutional strength is expected to support continued structural reform. While largely sharing much of the agencies' reasoning, we would argue that the government's recent loss of majority in parliament reduces the chances for the effective implementation of their structural reform agenda in the near-term.

Political situation and reforms

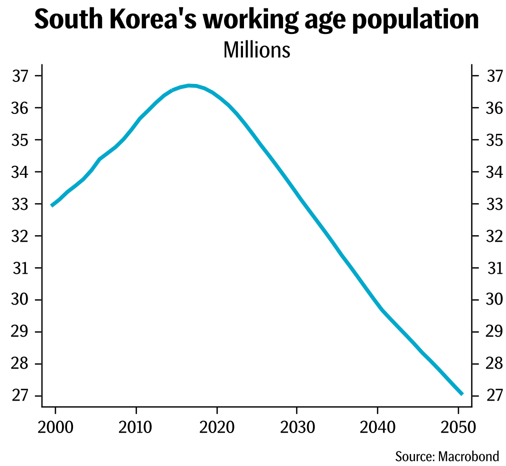
Government loses parliamentary majority. A very slim majority in a parliament and a constitution which often requires a 60% majority for a bill to become law has made it difficult for the government to make progress on structural economic reforms in the past years. Following parliamentary elections in April 2016, the conservative Saenuri party failed to keep its small parliamentary majority winning just 122 out of 300 seats. This has increased the government's headwinds further and raised the uncertainty on the direction of economic policy going forward. Many observers have remarked that the elections largely have rendered President Park a lame duck until presidential elections in December 2017.

The main thrust of economic policies is focused on corporate restructuring. Other important reforms, in particular relating to the labour market, are likely to lose momentum and the government is generally expected to turn to further macro stimulus.

Outlook

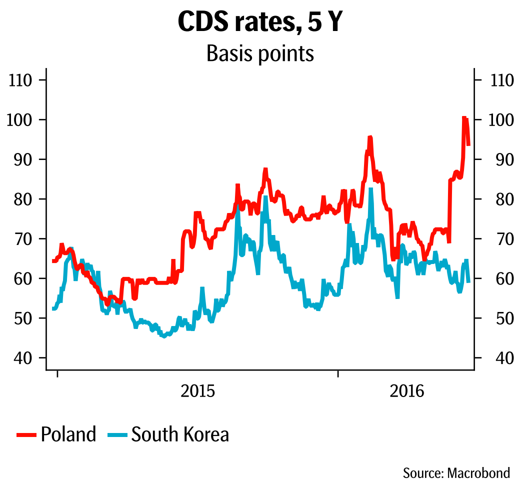
Weak near-term growth. Falling exports to emerging market economies are likely to largely outweigh any positive effects on the Korean economy coming from cheaper oil. Since the beginning of the year several observers have adjusted downwards their projections for near-term economic growth. One reason is that the government-led corporate restructuring process may increase downward pressures on the economy. Our forecasters, Oxford Economics, and the OECD both forecast 2.7% growth in 2016. Bank of Korea projects a similar pace while the government is slightly more optimistic (3.1%).

Declining level of potential growth is a risk. While economic growth remains above most developed economies, the IMF has noted that Korea's potential growth rate has declined significantly. One of the main reason for the decline is Korea's poor demographic structure. The working age population is expected to peak in 2016. Then the ratio of elderly to the working age population will rise faster than most other countries indicating that by 2050 Korea may be one of the oldest countries in the OECD.



Export led growth model is another risk. Korea has thrived for many years being an exporting powerhouse with a diverse set of export destination and products. However, this export driven growth model may be at risk in the longer term. The manufacturing sector is faced with increased competition from China's industry. At the same time the prices of Korean exports, not only petroleum products, have been declining for several years while labour costs have been rising.

Threat from North Korea remains the main event risk. External security presents an important tail-risk event and we do put a relatively high weight on a low probability event involving a collapse of North Korea or a significant military escalation. Our view on the probability and outcome of such a tail-risk event has not changed materially in the past year. The situation remains tense.

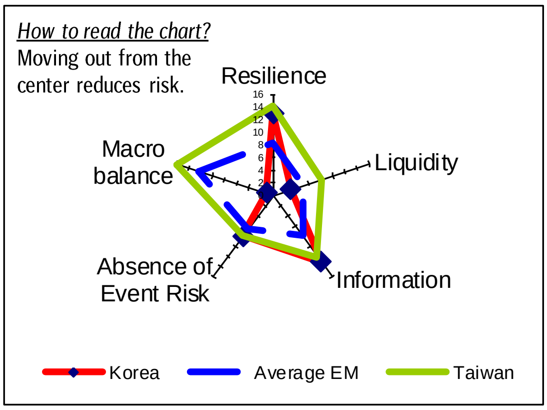


In early 2016, the joint industrial zone between the North and the South, usually seen as the last real point of contact between the two, was closed down. Moreover, in March 2016, following new North Korean weapons tests, the United Nations strengthened their sanctions against the country and South Korea cut off all humanitarian assistance. Meanwhile, amid significant geopolitical tensions in East Asia, Korea continues to have a very close working relationship with the US and continues to repair its ties to Japan.

Korea: Risk Indicators

Key ratios	2016
Population (mn.)	50.5
GDP/capita (USD)	27139
GDP (% change)	2.7%
Inflation	1.4%
Current Account Balance/GDP	6.7%
Reserves/imports (months)	10
Budget balance/GDP	-0.4%
Government debt/GDP	39%

External ratings:	Peers:
Fitch: AA-	Poland
S&P: AA-	Czech Republic
Moody's: Aa2	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.

KOREA: KEY ECONOMIC INDICATORS

Key data:	2012	2013	2014	2015	2016	2017	2018	2019
GDP (USD bn)	1223	1306	1412	1379	1371	1416	1497	1582
GDP/capita (USD)	24642	26190	28188	27404	27139	27912	29403	30965
GDP (change)	2.3%	2.9%	3.3%	2.6%	2.7%	2.8%	3.1%	2.6%
Investments/GDP	29%	29%	29%	29%	29%	29%	30%	30%
Government finances								
Budget balance/GDP	1.3%	1.0%	0.6%	0.0%	-0.4%	-0.5%	-0.4%	-0.4%
Govt debt/GDP	32%	34%	35%	36%	39%	40%	42%	43%
Money and prices								
CPI inflation	2.2%	1.3%	1.3%	0.7%	1.4%	1.8%	2.2%	2.2%
Money demand (change yoy)	10%	10%	12%	16%	18%	17%	15%	15%
Stock prices, index	1931	1961	1982	2012	2001	2119	2255	2478
Interest rates	3.3%	2.7%	2.5%	1.7%	1.6%	2.4%	2.7%	2.9%
Exchange rate (USD)	1127	1095	1053	1131	1180	1194	1183	1175
Trade/GDP	107%	97%	85%	80%	76%	76%	79%	81%
Oil price (Brent)	$112	$109	$99	$52	$42	$50	$60	$61
Balance of payments (USD, bn)								
Export of goods	680	676	645	620	585	602	655	707
Imports of goods	624	586	551	484	452	474	524	576
Current account	51	81	84	106	93	89	93	93
as % of GDP	4.2	6.2	6.0	7.7	6.7	6.1	6.4	5.5
FDI (net)	-21	-16	-19	-23	-19	-19	-21	-22
Loan repayments (USD mn)	-86	-79	-83	-79	-71	-69	-68	-69
Net other capital flows (USD mn)	70	27	45	3	5	4	1	13
Balance of payments	14	13	28	7	8	4	5	16
Debt and liquidity								
Reserves	310	323	352	359	367	371	377	393
Total debt	412	417	438	412	390	407	440	480
o/w short term debt	135	117	125	117	104	96	87	79

Source: Oxford Economics, IMF

Rating history (eoy)				
Fitch	A+	A+	AA-	AA-
Moodys	A1	A1	Aa3	Aa2

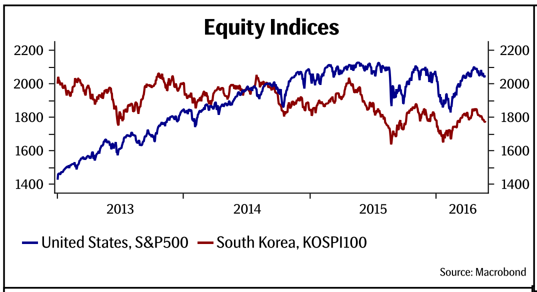
Type of government:

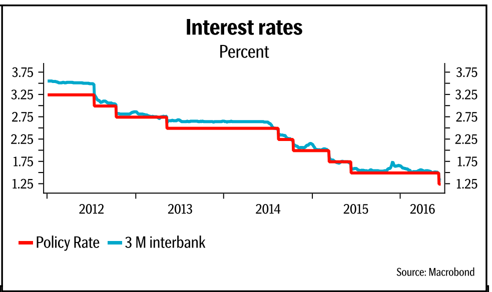
Next elections — Presidential: 2017 — Legislative: 2020

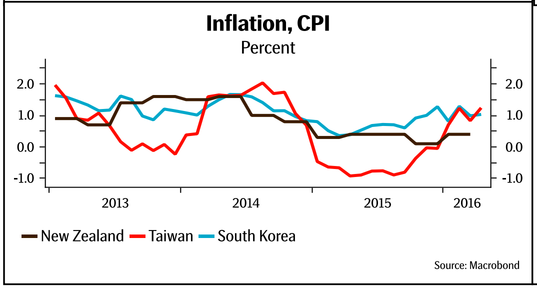
Other:

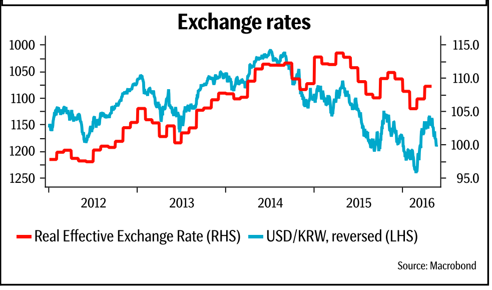
Latest PC deal — None

Latest IMF arrangements — Stand-by 1997









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