Republic of Korea

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Risks of an immediate military conflict with North Korea, one of the key negative factors for country risk in South Korea, has declined following the past months unexpected rapprochement. However, it may take years before we can factor in any sizeable and sustained reduction in regional geopolitical risk. Meanwhile, expansionary economic policies have lifted economic growth to decent levels, market sentiment has been positive, even during the past year's sabre rattling from the North, and external balances which is one of the country's key strengths have remained in good shape.

Country Risk Analysis

Recent economic developments

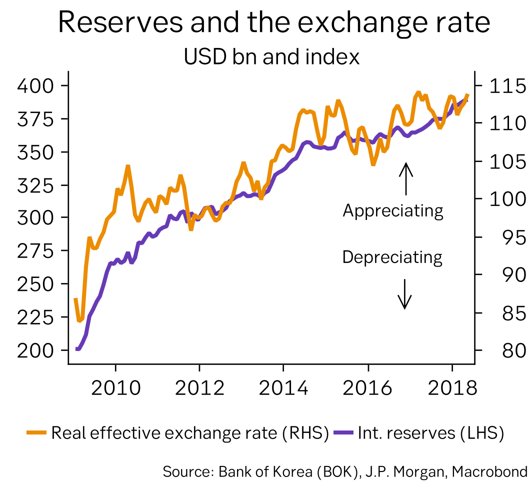
Steady economic growth. Growth gained pace last year with real GDP expanding by 3.1%, up from 2.9% in 2016, on the back of strong domestic demand in general and investment activity in particular. The expansion continued at a steady pace in the first quarter of 2018. China has eased the restrictions on tourist travel to Korea that were imposed following the deployment of the US built THAAD missile shield. Subsequently, tourist arrivals (of which nearly half normally comes from China) has started to recover. While economic growth is low compared to the average rates in the past decade, it compares favourably with rating peers. In addition, the historical volatility of GDP growth rates is low compared to other similarly rated economies, showing the economy's resilience despite its openness. The level of GDP per capita is still lower than most risk rating peers.

Headline inflation below the central bank target. Inflation picked up to an average rate of 1.9% in 2017, broadly in line with the central bank's 2% target. Since then, lower food and energy prices have helped to reduce the inflation rate to 1.3%.

Still strong external accounts. Korea has had solid surpluses on both the trade and current account during a long period, making up one of the economy's key credit strengths. In 2017 the surplus declined slightly as a share of GDP to 5.1% following a surge in imports of capital goods. This still relatively high surplus is partly due to the country's rapidly aging population with an increasing proportion preferring to save. Capital inflows rose significantly last year on the back of record high inward foreign direct investments. This being said, capital outflows continued to surpass inflows making it less pressing for the central bank to intervene to stop the exchange rate from appreciating too much for their liking. Still, the currency appreciated more against the US dollar than any of the major Asian currencies in 2017, but has weakened slightly in 2018.

Positive market sentiment. Household and business sentiment improved significantly following the election of President Moon in 2017. In a similar way, financial market sentiment has been positive over the past year, despite the sabre rattling from North Korea. A stronger currency and record FDI flows were two reflections of that. In addition, inflows of equity investment contributed to pushing up the main equity index to record highs towards the end of the year. Since then it has moderated in contrast to the equity market in the US, for example.

Net international investment position positive and external debt is low. The net international investment position (the balance between the economy's foreign assets and liabilities) has been positive since 2015 reducing one of the economy's past vulnerabilities. External debt, mostly held by banks, is on a gradual decline and was equivalent to about 24% of GDP in 2017. This is low compared to peers.

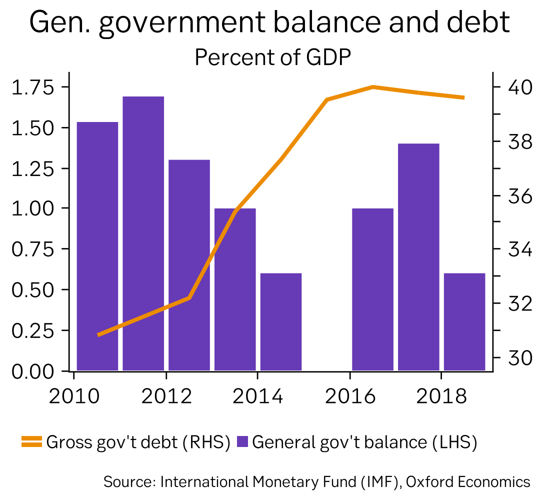


Foreign currency reserves at comfortable level. The surplus in the current account has produced a rising trend in foreign reserves. At current levels, Korea maintains import coverage of more than 8 months which should be considered as more than satisfactory given the country's floating exchange rate.

Policies

Fiscal policy remains expansionary. One of the government's top political aims is to boost incomes and household spending. Recent measure to this end includes a permanent rise in welfare spending starting in the current budget and the largest hike in the minimum wage in nearly two decades. Public sector hiring has also been stepped up in order to create jobs. Higher corporate taxes and a more progressive income tax are expected to partly finance the stepped-up spending. Despite this, observers such as the IMF are suggesting there is room for additional spending to support growth. The budget deficit has hovered just above 1% of GDP in the past couple of years. Adding the country's social security funds, however, the budget balance showed a small surplus in 2016 and 2017.

Government debt is moderate. Government debt remains moderate at about 40% of GDP, broadly in line with that of risk class peers. Most analysts expect debt to GDP to remain around this level in the near-term. Adding also the debt of the non-financial public corporate sector which is slowly declining (although data is lagging) yields a debt ratio of more than 60% of GDP.



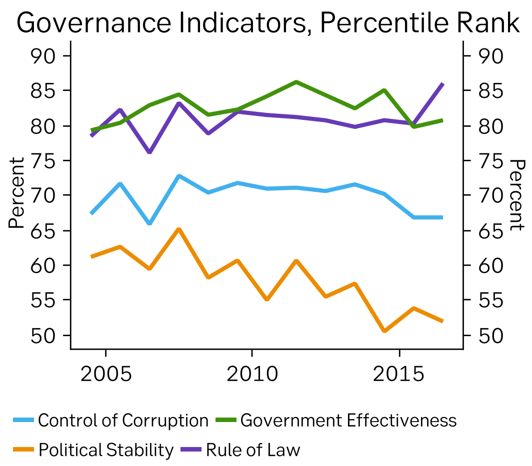
Interest rates hiked but monetary policy is still expansionary. As the first central bank in Asia, Bank of Korea (BOK) raised interest rates to 1.50% in late 2017, the first hike in six years, signalling a gradual normalisation of policy. With inflationary pressures being muted, a very gradual pace of continued hikes is expected.

High household debt remains a key challenge. High and rising household debt remains somewhat of a concern. In 2017, the authorities took several measures to stem the rise in indebtedness, including tighter mortgage rules and limits on multiple home ownership. The growth in household lending has subsequently fallen. Nevertheless, in the third quarter of 2017 household debt as a share of GDP had risen to 94.1%. Debt to disposable incomes has inched up to about 155%. At the same time, households' financial assets have risen and are equivalent to more than twice the size of their debt. This is a mitigating factor.

Although it is subject to great academic discussion exactly what level of household debt is too high, we note that the current levels are higher than in most countries in a similar country risk class. They are also higher than in most advanced economies. The main risk attached is growth related as household spending may be stifled once interest rates start to rise (as debt servicing gets increasingly expensive). With consumption making up around half of GDP this would pose a risk to overall economic growth. 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.

Corporate debt is relatively high but stable. Corporate debt remain stable at levels slightly higher (as a share of GDP) than most other countries in similar risk classes. An off-setting factor is that Korea's corporate debt is almost entirely domestic currency-denominated which reduces risks associated with a depreciation of the exchange rate.

Weak governance but attractive business climate. Korea has strong institutions, well in line with most advanced economies. However, the corruption related scandals leading to the impeachment of the former president Park put the spotlight (once again) on the close and often murky relationship between the government and the large chaebols (family owned conglomerates). This is one weakness which weighs on the overall quality of governance. Several World Bank governance indicators are weaker than average among similarly rated economies. In this context, it is promising that one of President Moon's main policy objectives is to crack down on the close relationship between the government and large business. Further on a positive note, Korea boasts an attractive business climate reflected in its fourth place out of 190 countries in the Doing Business rankings.



Source: World Bank

Financial sector

Banking system is largely sound and well capitalised. The banking sector in Korea is large with total assets amounting to more than 200% of GDP. Aggregate vulnerability indicators have improved considerably since the global financial crisis and largely reflect a sound and well capitalised banking sector. Macro prudential regulations were tightened further in 2017, mainly aimed at containing the risks from high household debt.

Political and geopolitical developments

Agreements with the North reduce military tensions. The unexpectedly rapid rapprochement between North Korea and South Korea and the (admittedly vague) agreement between the leaders of the North and of the US are actions that have the potential to reduce country risk in Korea. Some would argue that geopolitical risk already has declined. We could go along with the notion that near-term risks of a military conflict have declined. However, we believe that it most likely will take years before we can factor in a sustained decline in North Korea related risk in the region. One reason is the North's poor track record in sticking to similar agreements. In addition, the contingent liability for Korea in the form of costs related to a potential reunification or a collapse of the Northern state, a major negative for country risk, will remain substantial for years to come. A reflection of the continued uncertainties was the very limited reaction in financial markets to the political agreements. Nor did the main sovereign credit rating agencies signal any major change of view regarding sovereign risk.

<u>Recent agreements between South Korea and North Korea and between the US and the North</u>

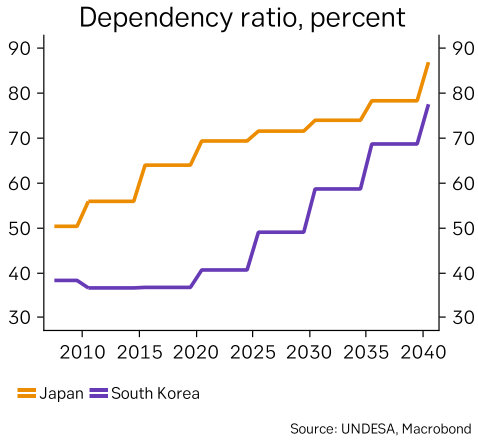
The meeting between the leaders of North and South Korea and the subsequent declaration, which includes the full implementation of all past intra-Korean agreements, is a good step towards establishing friendlier relations between the two states. It should thus improve the security situation in the near-term. The agreement between the US and the North will also mean that the two are unlikely to be trading threats of nuclear war in the near-term. The agreements' commitment to work towards denuclearization, on the other hand, should be viewed with plenty of caution. The North has invested extensive resources and much prestige in the nuclear arena, putting the country in a stronger negotiating position and is unlikely to completely step down from this position in the near-term. North Korea also has a history of backtracking on its commitments although some observers view it as slightly less likely that they backtrack completely on the recent agreement with the South this time around. The new declaration is full of details and has been well communicated to the North Korean population through public news channels.

Possibly working in the opposite direction to the positive developments are reported US plans to possibly reduce its military personnel in Korea and to scale down future joint military exercises. This, however, could be seen as a logical consequence of the movement towards a more peaceful environment and should be manageable for South Korea.

Outlook

Broadly stable near-term growth. Growth, which started the year strongly, is expected to edge down slightly during 2018. Our forecasters, Oxford Economics, expect GDP to expand 2.7% which is just shy of Bank of Korea's 3% forecast. Economic policies are expected to remain expansionary.

Demographic structure poses risk to longer-term growth and government finances. Like in many economies, Korea's potential growth rate has declined significantly in the years following the global financial crisis. The decline in Korea is amplified by low productivity and a rapidly aging population. The working age population peaked in 2016, and the ratio of elderly and young to the working age population (dependency ratio) is projected to rise faster than in most other OECD countries.



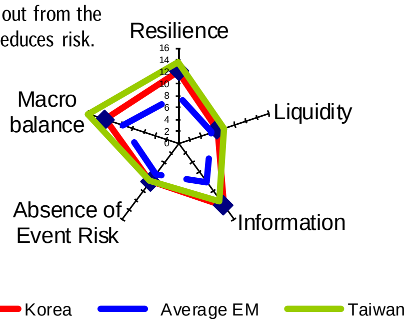
Export led growth model is a potential vulnerability. Korea's high degree of integration in global value chains and in the regional economy of Asia makes it vulnerable to shifts in foreign demand, for example a slowdown in China or further changes in US trade policy (US takes about 12% of its exports). In the longer term, the country's export driven growth model may also come under threat from an increasingly competitive Chinese economy. Although China currently is Korea's most important export market taking 25% of exports, it is also a competitor in many markets.

North Korea poses the main risk. External security continues to present the most important tail-risk event. We put a relatively high weight on the low probability event involving a collapse of North Korea which would put immediate and sustained pressure on Korea's finances or a significant military escalation. The probability of a near-term military escalation has declined following the past months' political rapprochement.

Korea: Risk Profile

Key ratios	**2018**
Population (mn.)	51.0
GDP/capita (USD)	33038
GDP (% change)	2.7%
Inflation	1.6%
Current Account Balance/GDP	3.2%
Reserves/imports (months)	8
Budget balance/GDP	0.6%
Government debt/GDP	40%

How to read the chart?
Moving out from the center reduces risk.



External ratings:	**Peers:**
Fitch: AA-	France
S&P: AA	Chile
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:	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
GDP (USD bn)	1412	1384	1415	1530	1691	1795	1881	1966
GDP/capita (USD)	28011	27337	27856	30009	33038	34953	36512	38043
GDP (change)	3.3%	2.8%	2.9%	3.1%	2.7%	2.6%	2.5%	2.5%
Investments/GDP	29%	30%	30%	32%	32%	32%	32%	32%
Government finances								
Budget balance/GDP	0.6%	0.0%	1.0%	1.4%	0.6%	0.5%	0.6%	0.6%
Excluding soc. security funds	-2.0%	-2.4%	-1.4%	-1.7%	--	--	--	--
Govt debt/GDP	36%	38%	38%	40%	40%	40%	40%	40%
Money and prices								
CPI inflation	1.3%	0.7%	1.0%	1.9%	1.6%	2.0%	2.1%	2.0%
Money demand (change yoy)	12%	16%	17%	13%	11%	9%	8%	8%
Stock prices, index	1982	2012	1986	2314	2520	2626	2731	2842
Interest rates	2.5%	1.7%	1.4%	1.4%	1.8%	2.3%	2.8%	3.3%
Exchange rate (USD)	1053	1131	1161	1131	1070	1053	1051	1052
Trade/GDP	85%	79%	74%	76%	73%	71%	71%	73%
Oil price (Brent)	$99	$52	$44	$54	$71	$70	$67	$68
Balance of payments (USD, bn)								
Export of goods	645	614	594	653	667	696	740	789
Imports of goods	552	475	456	517	561	579	605	640
Current account	84	106	99	78	53	65	80	91
as % of GDP	6.0	7.7	7.0	5.1	3.2	3.6	5.2	4.6
FDI (net)	-19	-20	-18	-15	-13	-17	-18	-19
Loan repayments (USD mn)	-83	-78	-71	-75	-79	-81	-83	-86
Net other capital flows (USD mn)	45	-2	-6	21	59	51	42	38
Balance of payments	28	7	4	10	21	18	21	24
Debt and liquidity								
Reserves	352	359	363	373	394	412	434	458
Total debt	437	410	392	411	426	436	448	461
o/w short term debt	125	113	105	117	118	121	124	128

Source: Oxford Economics, IMF

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

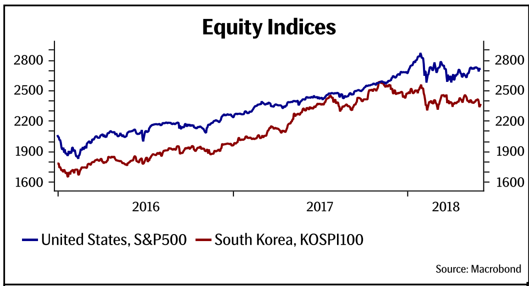
Type of government:

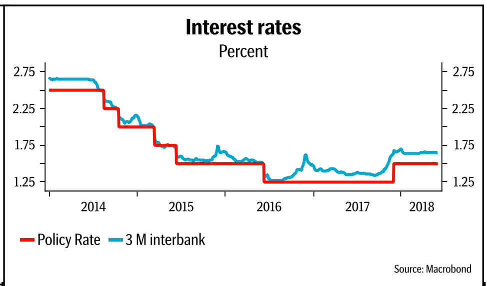
Next elections — Presidential: 2022 — Legislative: 2020

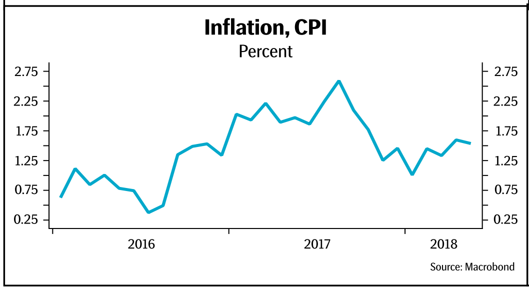
Other:

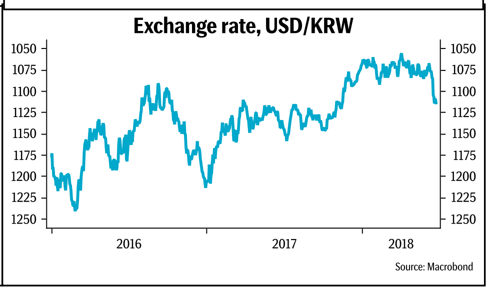
Latest PC deal — None

Latest IMF arrangements — Stand-by 1997









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