Economic Research

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Nor Zahidi Alias
Chief Economist
+ 603 2092 5398
zahidi@marc.com.my

Mohd Afzanizam Abd. Rashid
Assistant Vice President
+ 603 2092 5398
afzanizam@marc.com.my

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www.marc.com.my

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In a nutshell

Why we think Korea has hit the bottom

■ Confidence has surged among consumers and businesses. This is mainly attributed to the unprecedented policy responses by the government, through stimulus measures; and the Bank of Korea (BoK), through rapid reduction in interest rates, that lowered the cost of businesses as well as consumers' debt burden. Consumer confidence, which reached a 7-year high in July, is benefiting from a more stable labour market condition. An expected improvement in the external sector is also prompting businesses to increase production to meet rising demand.

■ A more stable macroeconomic condition, reflected in the slower GDP contraction in 2Q2009, is giving a psychological boost to consumer and business confidence. This is evidenced by a turnaround in investment activities, which soared by 2.9% after two consecutive quarters of negative growth. Consumer spending also rebounded, growing by more than 3% on a quarter-on-quarter (q-o-q) basis after contracting in the preceding quarter, while exports jumped by a double-digit rate after posting two quarters of deep contractions.

■ The banking sector remains resilient, evidenced by rising net income and declining loan loss provisions in 2Q2009. Asset quality continued to improve, and the number of new delinquency cases has dropped following improvements in capital market activities. The Bank for International Settlement (BIS) capital ratio also climbed to almost 13%, suggesting that banks have lending capacity.

■ The balance of payment (BoP) position has improved after being dented by massive capital outflows since the onset of the sub-prime crisis in the US in late 2007. The Korean Won (KRW) has stabilised to around KRW1249.7 per USD, after experiencing a sharp depreciation in early March. Current account of balance of payments has turned positive in the past five months, signaling that the risk of a credit crunch is slowly abating.

What could go wrong?

■ Inflationary pressure is slowly creeping in and may lead to a premature normalisation of the policy rate. Judging by monthly changes, consumer prices have registered positive increments in the past five months. Thus far, we take comfort from the tone of BoK's statement indicating that slower demand-pull pressures and currency appreciation will ease inflationary conditions in the economy. However, the risk lies in the timing of normalization of policy rate by the central bank.

■ Despite more "green shoots" seen in the global economy in recent months, the risk of a prolonged recession in advanced economies cannot be ruled out. The waning effect of fiscal stimuli will slowly weaken global economies if private sectors remain inactive. Being an open economy, South Korea will need a major boost from a turnaround in global trade in order to have a sustainable growth.

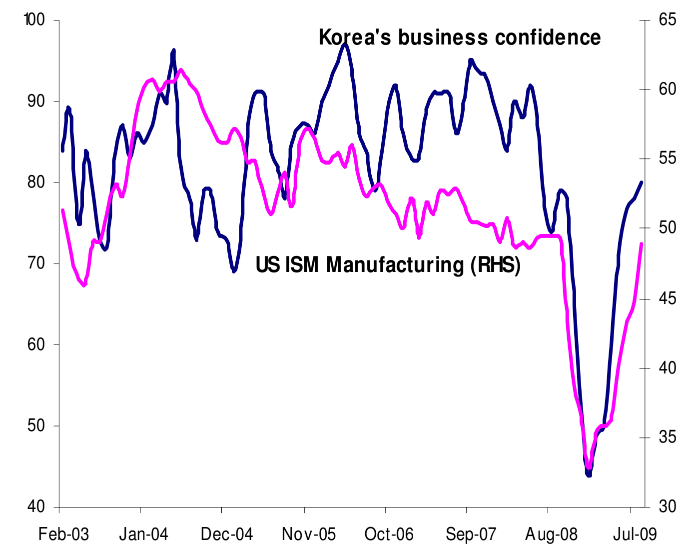
The worst could be over…

Rising optimism in consumer and business sentiment

The confidence level is running high for both consumers and businesses, thanks to unprecedented and fruitful policy responses by governments and central banks across the globe. In July 2009, the consumer confidence index reached 109 points, the highest level in seven years while the business confidence index touched an all time high of 80 points in August. In the same vein, the weaker currency as well as rising external demand have led to a surge in profits in big companies such as Samsung (+5.2% y-o-y) and Hyundai (+48.0% y-o-y) in 2Q2009.

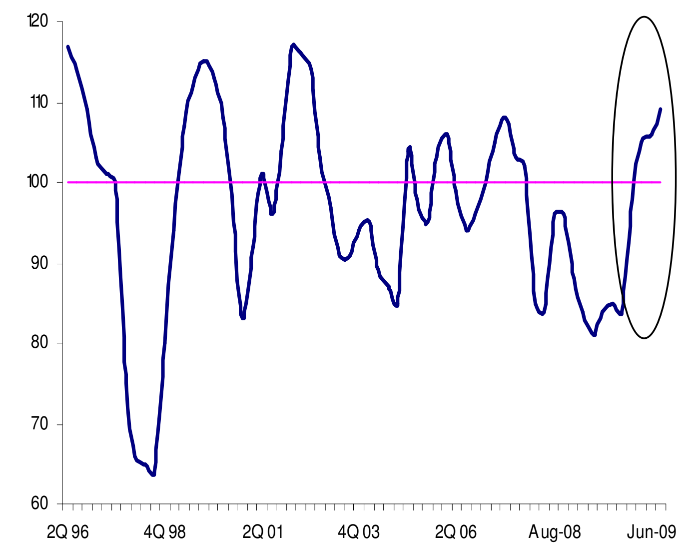
Rising profitability will likely translate into higher investment activity as companies start to gear up for higher production to meet rising external demand in the immediate term. A sharp improvement can also be seen from a slower contraction in the industrial production index (IPI) in June, which declined mildly by 1.2% compared with a 9.0% contraction recorded in the preceding month. Moreover, the IPI has gained strength in recent months, judging by the sequential increases in 4 out of 6 months this year. In June, it expanded by 5.9% on a month-on-month basis. On top of that, the unemployment rate has probably reached its peak when the jobless rate fell by 0.2 percentage points to 3.9% in July this year.

Chart 1: Business survey composite manufacturing index & US ISM manufacturing index



Source: Bloomberg

Chart 2: Consumer confidence index



Source: Bloomberg

Improvement in real economic activity

A milder GDP contraction in 2Q2009 reinforces the view that the economy is on the mend. Output loss has moderated to 2.5% from -4.2% and -3.4% recorded in 1Q2009 and 4Q2008 respectively. More importantly, positive changes on q-o-q basis (2Q2009: +2.3% q-o-q and 1Q2009: +0.1% q-o-q) suggest that the economy has escaped a recession. Further scrutiny shows that investment activities are finally turning for the better, expanding by 2.9% in 2Q2009, after posting two consecutive quarters of contractions (-0.4% in 1Q2009 and -6.5% in 4Q2008). Similarly, private consumption climbed 3.3% from the previous quarter (1Q2009: -0.5%). On the external front, real exports posted a double-digit growth of 11.2% after remaining negative in the past three quarters, while imports rose 8.8% compared with -8.4% and -14.2% in 1Q2009 and 4Q2008 respectively.

Besides the general improvement in external demand, the government policy response has played a critical role in stabilising the economy. The IMF, in its Article IV consultation paper on August 9, commended the move by the BoK to set aside US$55 billion in foreign exchange reserves in order to address the problem of capital outflows which emerged after the collapse of Lehman Brothers in September last year. The facility provided swaps or loans, and effectively substituted for loans previously provided by foreign creditors. Apart from that, aggressive rate cuts by the BoK totaling 325 basis points between October 2008 and February this year as well as fiscal stimulus measures amounting to 3.6% of GDP have averted a prolonged contraction in the economy.

Table 1: Korea's GDP growth

Y-o-Y%	2Q 07	3Q 07	4Q 07	1Q 08	2Q 08	3Q 08	4Q 08	1Q 09	2Q 09
Final Consumption Expenditure	5.4%	5.3%	4.7%	3.9%	2.6%	2.0%	-2.0%	-1.9%	0.7%
Private	5.2%	5.4%	4.6%	4.0%	2.3%	1.3%	-3.8%	-4.4%	-1.0%
Government	5.9%	4.8%	4.9%	3.7%	3.8%	4.5%	4.8%	7.4%	7.0%
Gross Fixed Capital Formation	5.8%	1.3%	3.0%	-0.6%	0.4%	1.6%	-7.9%	-6.8%	-4.1%
Intangible Fixed Assets	5.5%	5.5%	4.5%	4.9%	7.3%	3.8%	2.1%	-4.2%	0.3%
Exports of Goods and Services	11.2%	9.3%	17.6%	10.6%	11.3%	9.0%	-6.9%	-10.8%	-3.4%
Imports of Goods and Services	11.8%	8.3%	15.6%	9.7%	8.5%	9.0%	-11.4%	-18.2%	-13.6%
Gross Domestic Product (GDP)	**5.3%**	**5.0%**	**5.7%**	**5.3%**	**4.2%**	**3.0%**	**-3.4%**	**-4.3%**	**-2.5%**

Q-o-Q%	2Q 07	3Q 07	4Q 07	1Q 08	2Q 08	3Q 08	4Q 08	1Q 09	2Q 09
Final Consumption Expenditure	1.5%	0.8%	0.5%	1.1%	0.2%	0.2%	-3.4%	1.2%	2.8%
Private	1.5%	0.9%	0.4%	1.1%	-0.2%	0.0%	-4.6%	0.5%	3.3%
Government	1.4%	0.4%	0.7%	1.2%	1.4%	1.1%	1.0%	3.7%	1.0%
Gross Fixed Capital Formation	-0.9%	-1.1%	3.1%	-1.6%	0.1%	0.1%	-6.5%	-0.4%	2.9%
Changes in Inventories	-418.5%	35.5%	-19.5%	79.9%	10.4%	28.0%	-114.3%	742.5%	55.0%
Exports of Goods and Services	2.1%	1.7%	6.5%	0.0%	2.7%	-0.4%	-8.9%	-4.3%	11.2%
Imports of Goods and Services	4.2%	0.6%	5.6%	-0.8%	2.9%	1.1%	-14.2%	-8.4%	8.8%
Gross Domestic Product (GDP)	**1.5%**	**1.3%**	**1.3%**	**1.1%**	**0.4%**	**0.2%**	**-5.1%**	**0.1%**	**2.3%**

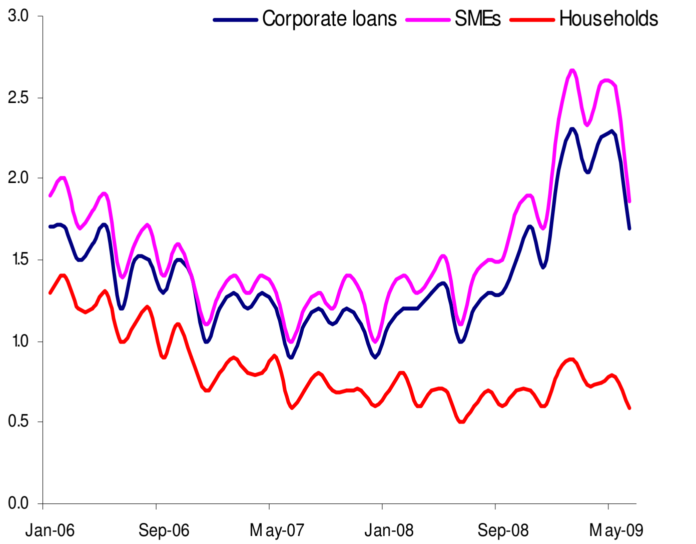
Source: Bank of Korea (BOK)

Resilient banking system

Thus far, Korean banks remain resilient, registering a higher net income of KRW2.3 trillion in 2Q2009, up from KRW600 billion in the preceding quarter. This came largely on the back of lower loan loss provision of KRW2.6 trillion against KRW4.5 trillion in 1Q2009 as banks' asset quality improved following a drop in the delinquency ratio to 1.19% in June from 1.45% in March. According to the Financial Supervisory Service (FSS), new delinquency cases have declined in tandem with improvements in the capital market. At the same time, reductions in write-offs as well as delinquent loans returning to good standing have significantly contributed to the decline in the overall delinquency ratio. Apart from that, the banks' BIS capital ratio climbed higher to 12.94% in March, up by 0.63 percentage points from end of 2008, implying that banks have the lending capacity as the ratio remained above its minimum threshold level of 8.00%.

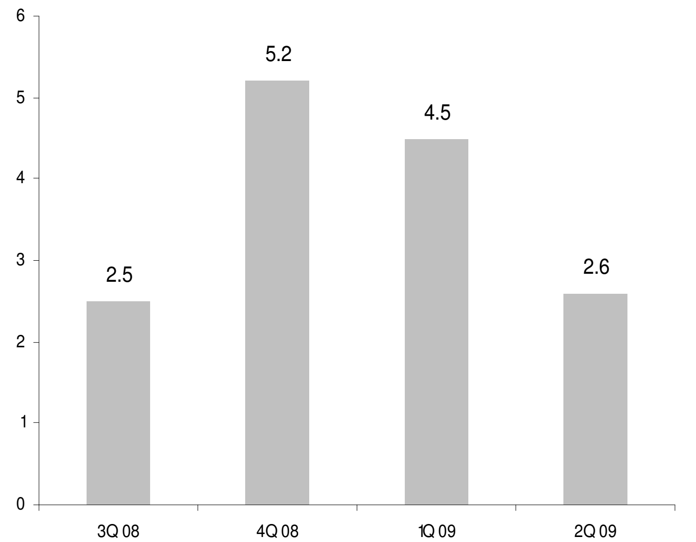
In a nutshell, conditions in the banking system remained favorable in tandem with the improvement in seen in the economy. This can be seen from the loan loss provision, which has declined as a result of the stronger economy in 1Q and 2Q2009.

Chart 3: Delinquency ratio %



Source: Financial Supervisory Service (FSS)

Chart 4: Loan loss provision (KRW trillion)

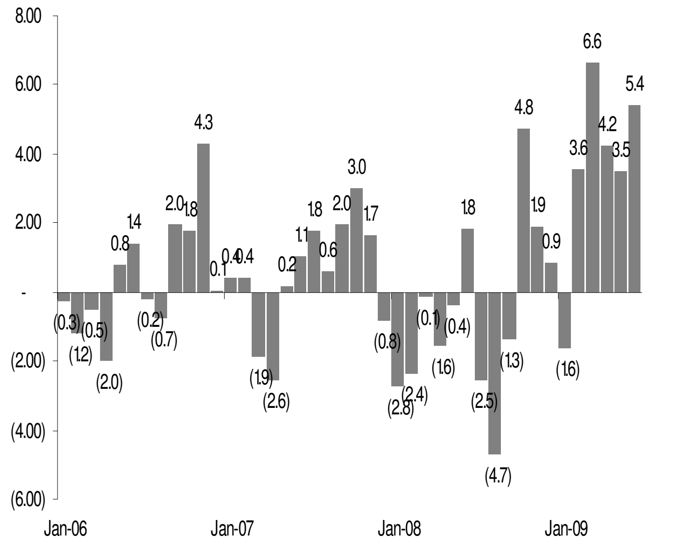


Source: Financial Supervisory Service (FSS)

Balance of payment – back to surplus

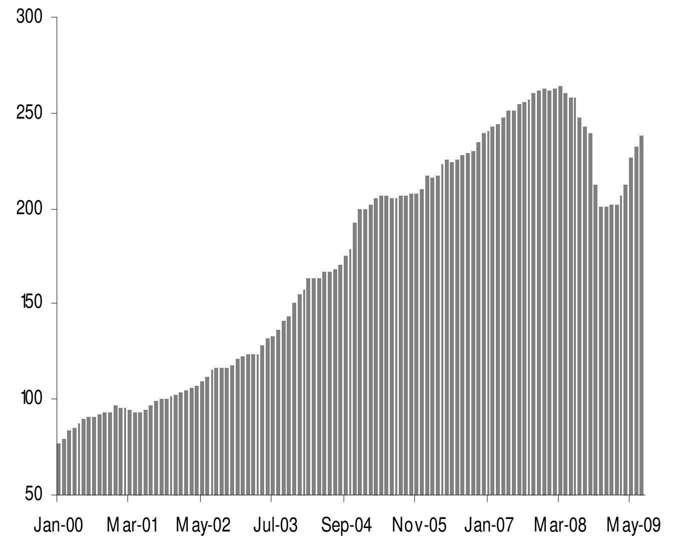
Korea's BoP position was severely dented when the US sub-prime woes heightened in 2H2008. Back then, massive capital outflows took place and resulted in depletion of foreign exchange (forex) reserves, which subsequently caused a sharp depreciation in the value of the KRW against the greenback. Of late, however, the capital flows have stabilised and forex reserves have started to climb since March 2009, leading to a 25% gain in KRW against the USD. In the same vein, the balance in the current account of BoP has turned into a surplus in the five months since February, signaling that the risk of a credit crunch is increasingly abating.

Chart 5: Current account in USD bn



Source: Bloomberg

Chart 6: International reserve assets (KRW bn)



Source: Bloomberg

…but what could go wrong?

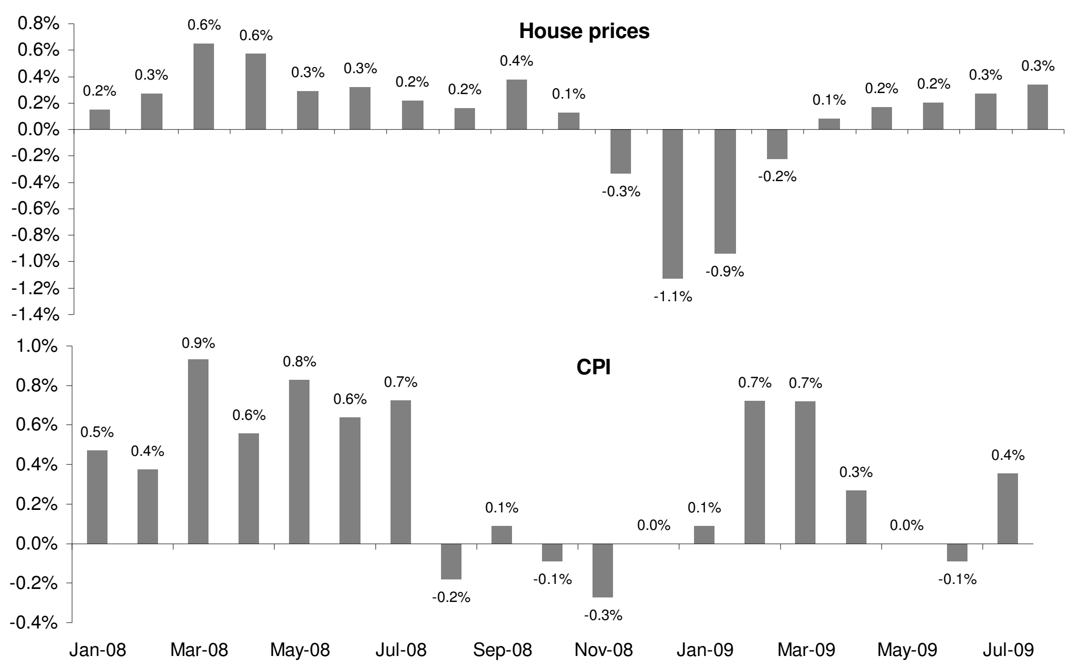
Eventual normalization of monetary policy

The concern over the timing of the normalization of policy rate has emerged following a build-up in the inflationary pressure as a result of a pick up in economic activity. On a month-on-month basis, the Consumer Price Index (CPI) has chalked positive growth in 6 out of 7 months this year, while house prices have been on the rise, suggesting that the accommodative monetary policy has led to higher asset prices. The real worry is the BoK's timing in normalizing interest rates as it could hamper the growth if it is done too soon.

So far, the message from the BoK is comforting. In its latest statement, the central bank sounded unperturbed by monthly positive changes in the CPI. Overall, according to the BoK, CPI inflation on a year-on-year basis has decelerated due to moderating demand-pull pressure and appreciation of KRW. At the same time, property prices have not risen significantly. It was on this basis that the BoK left its key rate unchanged during its policy meeting on August 11.

Notwithstanding that, we are cautious on the timing of the withdrawal of policy accommodation as it could dampen domestic demand at a time when external demand remains fragile. As such, we cannot rule out the downside risk on economic growth if the central bank decides to prematurely normalise the policy rate in the near term.

Chart 7: Inflation rate is on the rise (m-o-m)



Source: Bloomberg

Risk of a prolonged recession in advanced economies

The latest GDP statistics revealed that global economic conditions have improved, with Japan, Germany and France posting positive growth while the US experienced a milder contraction in 2Q2009. While the “green shoots” seem to be blooming, several factors may hinder a smooth recovery of the global economy. Firstly, the recovery is mainly attributed to governments’ stimulus efforts and accommodative monetary policies. Once the effect of the stimuli wane in 2010, the recovery phase will likely be much bumpier, especially if the private sector remains inactive. Secondly, risk aversion could return if investors start to feel uneasy about the pace of acceleration in equity prices. For instance, China’s stock market has declined by 19% since reaching its peak as investors start to rationalize their decisions based on fundamentals. Thirdly, the pressure to normalise interest rates could lead some central banks to remove policy accommodation too soon, denting domestic demand at a time when global trade remains fragile.

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Country Fact Sheet

	2001	2002	2003	2004	2005	2006	2007	2008
National Account (growth %)								
Gross Domestic Product	**4.0%**	**7.2%**	**2.8%**	**4.6%**	**4.0%**	**5.2%**	**5.1%**	**2.2%**
Supply side								
Agriculture, forestry and fishing	1.6%	-2.2%	-5.4%	9.1%	1.3%	1.5%	4.0%	5.5%
Mining and quarrying	-0.8%	0.1%	3.5%	-0.4%	-0.4%	-0.1%	-4.1%	1.3%
Manufacturing	2.4%	8.7%	5.4%	10.0%	6.2%	8.1%	7.2%	3.1%
Construction	5.4%	3.5%	8.8%	2.0%	-0.3%	2.2%	2.6%	-2.4%
Services	4.4%	7.4%	1.8%	2.5%	3.7%	4.4%	5.1%	2.6%
Demand side								
Final Consumption Expenditure	5.5%	8.1%	0.5%	1.0%	4.6%	5.1%	5.1%	1.6%
Private	5.7%	8.9%	-0.4%	0.3%	4.6%	4.7%	5.1%	0.9%
Government	5.0%	4.9%	4.4%	3.8%	4.3%	6.6%	5.4%	4.2%
Gross Fixed Capital Formation	0.3%	7.1%	4.4%	2.1%	1.9%	3.4%	4.2%	-1.7%
Exports of Goods and Services	-3.4%	12.1%	14.5%	19.7%	7.8%	11.4%	12.6%	5.7%
Imports of Goods and Services	-4.9%	14.4%	11.1%	11.7%	7.6%	11.3%	11.7%	3.7%
Balance of Payments								
Current Account ($ Million)	8,033	5,394	11,950	28,174	14,981	5,385	5,876	(6,406)
% of GDP	1.7%	1.0%	2.0%	4.1%	1.9%	0.6%	0.6%	-0.7%
Capital Account ($Million)	(3,391)	6,252	13,909	7,599	4,757	17,972	7,128	(50,933)
% of GDP	-1%	1%	2%	1%	1%	2%	1%	-5.6%
Official Reserve Asset ($Million)	102,821	121,413	155,352	199,066	210,391	238,956	262,224	201,223
Government Finance								
Revenue (KRW Bn)	144,033	158,712	171,945	178,760	191,446	209,573	243,633	250,713
% of GDP	23.2%	23.2%	22.4%	21.6%	22.1%	23.1%	25.0%	24.5%
Expenditure (KRW Bn)	136,765	136,046	164,303	173,538	187,946	205,928	209,810	238,834
% of GDP	22.0%	19.9%	21.4%	21.0%	21.7%	22.7%	21.5%	23.3%
Fiscal Balance (KRW Bn)	7,268.0	22,666.0	7,642.0	5,222.0	3,500.0	3,645.0	33,823.0	11,879.5
% of GDP	1.2%	3.3%	1.0%	0.6%	0.4%	0.4%	3.5%	1.2%
External Debt								
Gross External Debt ($ Million)	128,687	141,471	157,394	172,259	187,882	260,061	383,152	381,057
% of GDP	27.2%	26.2%	26.3%	25.1%	23.8%	29.0%	38.5%	41.6%
Money & Banking								
M1	18.0%	22.5%	6.9%	8.3%	8.5%	-0.8%	-5.2%	-1.8%
M2	6.9%	11.5%	7.9%	4.6%	6.9%	8.3%	11.2%	14.3%
M3	9.6%	12.9%	8.8%	6.1%	7.0%	7.9%	10.2%	11.9%
Loan-to-deposit	71.5%	76.4%	79.3%	81.0%	81.7%	83.2%	87.5%	88.2%
Deliquency Ratio								
Loans to Enterprise	1.9%	1.8%	1.9%	1.8%	1.3%	1.0%	0.9%	1.5%
Loans to Households	1.3%	1.5%	1.8%	1.7%	1.1%	0.7%	0.6%	0.6%
Loans to Credit Card	7.3%	8.5%	7.8%	4.1%	2.2%	0.1%	1.3%	2.1%
Labor Market								
Unempoyment Rate	4.0%	3.3%	3.6%	3.7%	3.7%	3.5%	3.2%	3.3%
Inflation Rate								
CPI	4.1%	2.8%	3.5%	3.6%	2.8%	2.2%	2.5%	4.7%

Source: Bank of Korea, Korea Statistical Information & CEIC