Economic Research

KDN No.: PP14787/11/2010(026023)

Country Update: South Korea

MALAYSIAN RATING CORPORATION BERHAD
(364803 V)

Vol.: ER/013/2010

Economics Team

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

Mohd Afzanizam Abd. Rashid
Economist
+ 603 2092 5398
afzanizam@marc.com.my

James Foo Kok Chye
Economic Analyst
+ 603 2092 5398
jamesfoo@marc.com.my

Please read the disclaimer on the last page of this report

The South Korean Economy

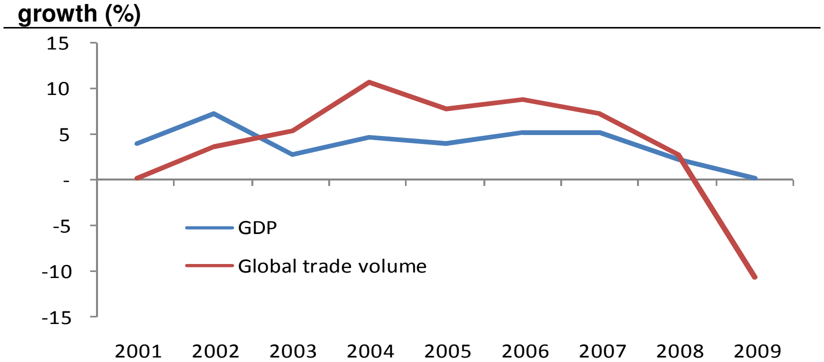
Overview

The economy was generally underdeveloped and largely agrarian up until the 1960s. The policy shift to export-oriented industrialisation within a short period of three-and-a-half decades has transformed it into a modern industrialised economy. Helped by the rapid growth, which averaged over 8.0% per annum for more than 30 years, its gross domestic product (GDP) volume soared from only USD2.1 billion in 1961 to USD557.4 billion by 1996, and its per capita gross national income (GNI) leapt dramatically from USD82 to USD12,197 over the same period. The government induced industrial restructuring by promoting heavy and chemical industries such as shipbuilding, iron and steel, automobiles, machinery and petrochemicals. Investments in these newly favored sectors were encouraged through tax and financial incentives. As a result, the share of heavy and chemical products in exports expanded from 13% in 1970 to 39% in 1979. Given its spectacular economic performance, the country emerged as one of the leading nations among the newly industrialising economies, and was able to become a member of the Organisation for Economic Cooperation and Development (OECD) in 1996. This outstanding economic achievement was truly remarkable considering the nation's limited endowment of natural resources.

Global economic crisis in 2008 and 2009

The world economic recession in 2009 took a serious toll on Asian economies as global trade tumbled by a massive 10.7% after growing at a moderate pace of 2.8% in 2008 (2007: 7.2%). South Korea was no exception: its GDP contracted for three consecutive quarters on the back of a rapid decline in exports during the final quarter of 2008. Fortunately, the economic malaise lasted for less than a year, thanks to swift policy responses by the monetary and fiscal authorities. The Bank of Korea (BOK) slashed its policy rate by a total of 325 basis points (bps) during the downturn to a historical low of 2%. The ruling government similarly announced a fiscal stimulus package amounting to 33 trillion Korean won (KRW) (4.0% of GDP) on December 13, 2008.

Chart 1: South Korea's GDP growth (%) vs. global trade volume growth (%)



Sources: CEIC & International Monetary Fund

Current trends

i) Intensifying production activities

The economy appears to be an immediate beneficiary of the revival in global demand. Production activities picked up the pace in 3Q2009, and have continued to chart double-digit growth rates since November last year. In May 2010, the industrial production index (IPI) rose 21.4% year-on-year (y-o-y), helped by the strong increase in the manufacturing sector (22.3% in May vs. 20.6% in April). Overseas shipments continued to grow at a respectable pace of 32.4% y-o-y in June (May: 40.5%), owing to better demand from abroad. Against this backdrop, the 1H2010 GDP posted a strong 7.7% expansion after experiencing a decline of 3.3% in the corresponding period last year. The manufacturing sector recorded a stellar performance, growing by 19.4% (1H2009: -10.4%), followed by an increase of 4.1% in the services sector (1H2009: -0.1%). On the demand side, investment activities as reflected in the gross fixed capital formation (GFCF) registered a swift turnaround to 8.8% in 1H2010 (1H2009:-4.9%), led by strong expansion in facilities investment of 29.5% (1H2009: -20.2%). Private consumption also recovered to 5.0% growth during the period under review (1H2009: -2.7%) as more jobs were created, as evidenced by the fall in the unemployment rate from its cyclical high of 4.9% in February this year to 3.5% in June.

Table 1: GDP (y-o-y%)

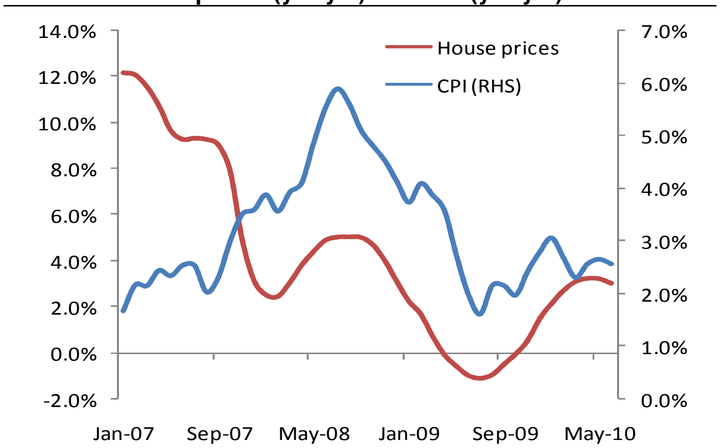
	1Q 09	2Q 09	1H 2009	3Q 09	4Q 09	2H2009	1Q 10	2Q 10	1H2010
Gross Domestic Product	**(4.3)**	**(2.2)**	**(3.3)**	**1.0**	**6.0**	**3.5**	**8.1**	**7.2**	**7.7**
Agriculture, forestry & fishing	1.5	(1.3)	0.1	3.3	2.8	3.1	(1.9)	(2.3)	(2.1)
Manufacturing	(13.6)	(7.2)	(10.4)	1.7	13.0	7.4	20.7	18.0	19.4
Electricity, gas & water	6.1	4.0	5.1	7.5	1.4	4.5	5.0	5.5	5.3
Construction	-	3.2	1.6	0.3	3.3	1.8	1.5	(0.5)	0.5
Services	(0.4)	0.3	(0.1)	0.9	3.0	2.0	4.4	3.7	4.1
Final consumption expenditure	(2.0)	0.7	(0.7)	1.7	4.7	3.2	5.7	3.6	4.7
(Private)	(4.4)	(1.0)	(2.7)	0.7	5.8	3.3	6.3	3.7	5.0
(Government)	7.2	6.7	7.0	5.3	1.1	3.2	3.8	3.2	3.5
Gross fixed capital formation	(7.4)	(2.3)	(4.9)	0.4	7.1	3.8	11.4	6.1	8.8
(Construction)	2.8	5.1	4.0	4.4	5.0	4.7	2.3	(2.7)	(0.2)
(Facilities)	(23.1)	(17.3)	(20.2)	(7.0)	13.3	3.2	29.9	29.0	29.5
Exports of goods & services	(10.7)	(3.4)	(7.1)	1.0	9.8	5.4	16.6	13.9	15.3
Imports of goods & services	(18.8)	(13.3)	(16.1)	(7.7)	8.7	0.5	21.0	19.0	20.0

Source: Bank of Korea (BOK)

ii) Normalisation of monetary policy

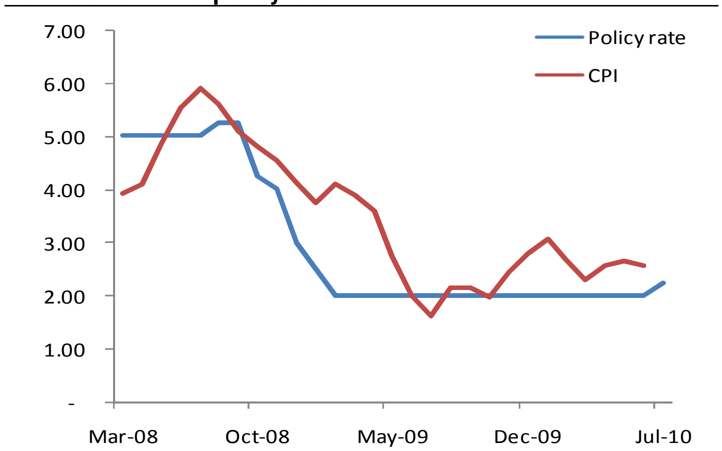
On July 9, the BOK decided to raise its policy rate by 25 basis points after remaining at 2.00% since early 2009 in response to improved external demand as reflected by the rise in exports as well as continued strength in the domestic engine. Nonetheless, looking at the pace at which the advanced economies are going, the monetary tightening can only happen gradually as the downside risk is quite apparent. Obviously, the BOK would have to weigh this against the need to ensure sustainable growth at a time when the global economy is still uncertain, while an increase in domestic activity, which could lead to capacity constraints, will warrant close scrutiny on inflation dynamics. Fortunately, inflationary pressures are well contained at this juncture with the consumer price index (CPI) and house prices continued to moderate in recent months. Hence, we expect the BOK will normalise its policy rate in baby steps.

Chart 2: House prices (y-o-y%) and CPI (y-o-y%)



Source: Bloomberg

Chart 3: CPI and policy rate

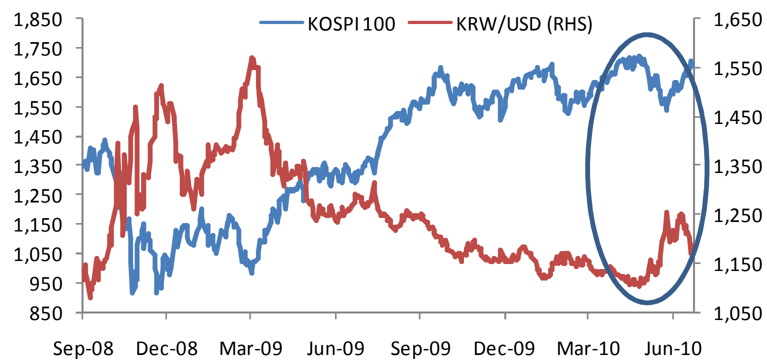


Source: Bloomberg

iii) Transnational issue – Cheonan sinking

The government has made public the findings of the international probe into the sinking of the Cheonan naval ship on March 26 which killed 46 sailors on board. The North Korean government was allegedly responsible, but the reclusive regime has persistently denied involvement in the matter, rubbishing such claims as mere fabrication by its southern counterpart in the ongoing spat between the two nations. As a result, the North Korean government has in retaliation issued a stern warning that an "all-out" war is inevitable, and it is set to impose a total freeze in inter-Korean relations. These chilling developments have sent jitters through to the financial markets, increasing the volatility of the stock and currency markets. Additionally, the sovereign-debt debacle in Europe may cause the financial markets to remain in a state of high volatility for some time. The KOSPI 100 accordingly retraced from its year's high of 1,721 on April 26 to 1,534.8 on May 25, a 10.8% decline. Similarly, the KRW depreciated against the USD by 13.3% between April 21 and May 26. However, since then, the KOSPI 100 has surpassed the aforementioned peak on account of the revival in global demand for the nation's semiconductors, electronic products and automobiles. The July 9 interest-rate hike also improved the KRW's attractiveness, resulting in the currency going on an appreciation trend.

Chart 4: Equity and currency markets



Source: CEIC

iv) Capital controls

On June 13, government officials introduced the New Macro Prudential Measures to Mitigate Volatility of Capital Flows. As the name suggests, the primary objective of these measures is to reduce excessive volatility of capital flows. These are the salient points:

- ✓ New limits for foreign-exchange (FX) derivative positions of domestic banks and foreign bank branches (FBB) will be established. The ceiling on domestic banks' FX derivative contracts will not exceed 50% of their capital, while FBB ceilings will be set at 250% of their capital (current level is at around 300%).
- ✓ Rules regarding the use of bank loans in foreign currency will be tightened, whereby foreign-currency financing may be used for overseas transactions only. Previously, such a facility could be used for the purchase of domestic facilities.

Our views

➢ **Moderation in short-term growth will not affect long-term prospects**

As with other Asian countries, the Korean economy experienced a V-shaped recovery, with GDP surging by 7.7% y-o-y in 1H2010 after posting contractions in the corresponding period last year. While the recovery was initially triggered by a turnaround in exports (which registered a 15.3% expansion in 1H2010 after contracting by 7.1% in 1H2009), encouraging signs can be seen from the acceleration in the growth of private consumption (1H2010: +5.0%; 1H2009: -2.7%). The nation's track record reveals that the government has always been pro-growth in terms of their policies. Even in 2003 and 2009, when economic activities slumped following the global financial crisis and the weakness of the consumer sector, the Korean economy managed to avert a recession. On that score, even with the anticipated slowdown in the global economy in 2H2010, we remain steadfastly positive about the overall growth prospects of the Korean economy.

- **BOK will remain behind the curve**

As policymakers are biased towards maintaining decent growth rates, the BOK will likely remain dovish despite recent government rhetoric about keeping a close tab on inflationary pressures. This is compounded by the fact that BOK's new governor has a strong inclination to support the government's objective of keeping growth intact, following anticipation of slower expansion in 2H2010. While the central bank has commenced its policy rate normalisation in an effort to avert a buildup in inflation or asset bubbles, rates are not likely to be raised aggressively, unless Asian economies experience sustained growth in the next few quarters. In addition, the recent de-pegging of the yuan is anticipated to strengthen the KRW which in turn would slow down the country's export sector in the near term.

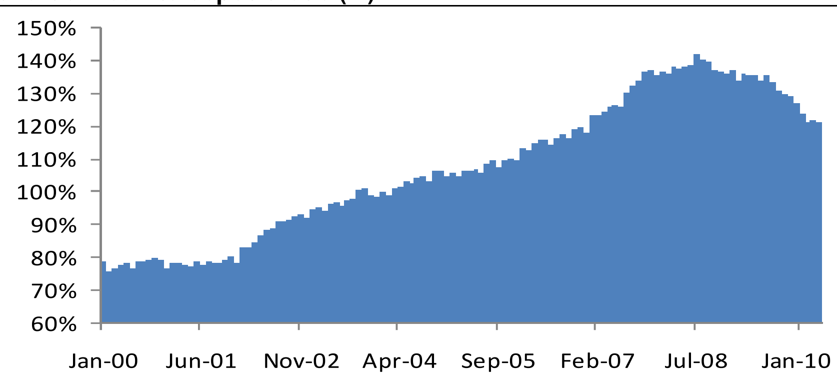
- **Higher volatility in the KRW in the short term**

Following the European debacle and the Cheonan incident, the KRW has been subjected to higher volatility. After steadily appreciating against the greenback since 4Q2009, the KRW depreciated by 13% in May before strengthening again in June. The volatility in capital flows, which to a large extent affects the movement of the KRW, has had a pronounced effect on the equity market. This in turn has influenced the trend of private consumption. We foresee increasing volatility in the KRW in the next six months as the impact of the European debacle continues to weigh on the global financial markets. Notwithstanding this, the longer-term picture looks promising as the government would closely monitor the flows of capital, as evidenced by its introduction of the New Macro Prudential Measures on June 13. In addition, the resilience of Asian economies will augur well for the trend in capital flows in a country with a deep capital market like South Korea.

- **Liquidity in the economy should remain adequate**

The issue of liquidity is worth noting. The Korean banking system is likely to be more susceptible to a reversal in capital flows. Its high loan-to-deposit ratio in excess of 100% (compared with a country like Malaysia, whose ratio is 80%) suggests that the banking system will be more affected due to higher leverage positions. A significant weakness of the global economy will have material repercussions on the Korean banking system, if no measures were to be taken in response to such conditions. However, the nation's strong fiscal position and the government's commitment to spending programs will help ensure that liquidity will not be severely affected by sudden capital outflows.

Chart 5: Loan-to-deposit ratio (%)

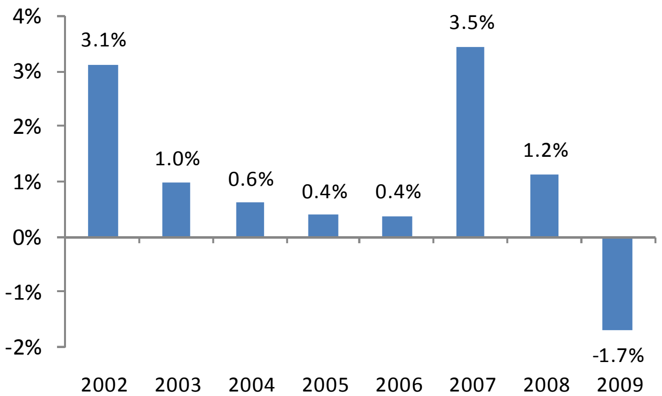


Source: CEIC

➢ Government finances and the current account balance to remain healthy

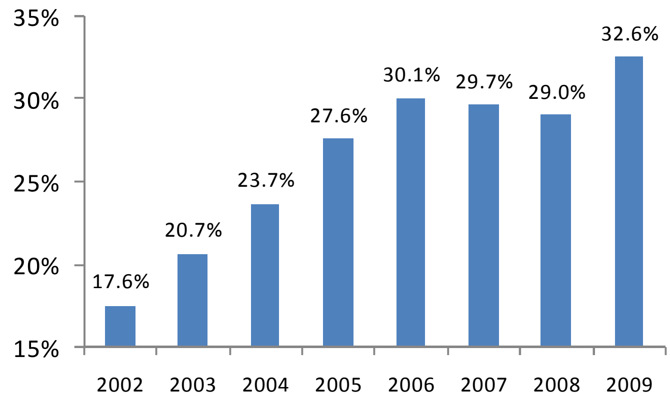
We take comfort in the government's financial position as it has proven to be strong, supported by prudent spending programs. This was evidenced by surplus balances being accumulated over the years. Understandably, the recent global economic crisis in 2008 and 2009 led the government to implement fiscal stimulus measures to avert a prolonged recession. According to OECD estimates in January this year, the country's fiscal stimulus program is forecast to account for 6.0% of GDP, the largest among the OECD members. In 2009, the country experienced a fiscal deficit of 1.7% of GDP after registering a surplus of 1.2% of GDP in 2008. In the same vein, the government debt level has risen to 32.6% of GDP in 2009 compared with 29.0% in the previous year. Despite the rise, a major portion of the debt was raised from domestic sources (about 97% of total debt composition). Against such a backdrop, we believe the government is in a good position to ensure that the country's economic performance will not be severely dented by negative developments in the external sector. In addition, the continued surplus balances in the current account in recent months suggest that there is ample liquidity to support economic activities. Hence, we opine that the risk of any credit crunch in future is somewhat remote at this juncture.

Chart 6: Central government balance (% of GDP)



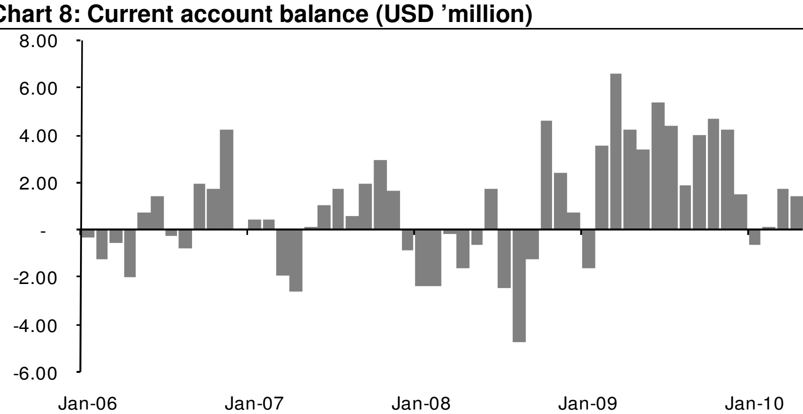
Source: CEIC

Chart 7: Central government debt (% of GDP)



Source: CEIC

Chart 8: Current account balance (USD 'million)



Source: Bloomberg

THIS PAGE IS INTENTIONALLY LEFT BLANK

Published and Printed by:

MALAYSIAN RATING CORPORATION BERHAD (Company No.: 364803 V)
5th Floor, Bangunan Malaysian Re, No. 17, Lorong Dungun, Damansara Heights, 50490 KUALA LUMPUR
Tel.: [603] 2092 5398 Fax: [603] 2094 9397 E-mail: marc@marc.com.my
Homepage: www.marc.com.my