

# Economic Research

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## Country Outlook: South Korea



**MALAYSIAN RATING CORPORATION BERHAD**  
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## In a nutshell

- Growth in 2011 slowed from the recovery year of 2010, with a 3.6% showing compared to 6.3% growth in 2010. Economic activity slowed throughout the year, with GDP growth dropping from 4.2% in 1Q2011 to 3.3% in 4Q2011. Going forward, we expect growth prospects to be challenging this year on the back of recession in Europe and slowing growth in China, which together take in nearly a third of Korea's exports. In its latest Economic Outlook, Bank of Korea (BOK) is forecasting GDP growth for 2012 to slow to 3.5% before recovering to 4.2% in 2013, with the advance estimate for 1Q2012 at 2.8%. We estimate Korea's trend growth for the last ten years to be about 4.3%. We believe growth has probably bottomed out in 1Q2012 before recovering as better prospects in the United States (US) and potential policy easing in China pave the way for stronger global growth. However, while we think Korea may potentially post better growth numbers than in 2011, above trend growth isn't likely to be on the cards.
- In line with the rest of the region, Korea's inflation rate has begun to moderate as commodity prices have come off market highs and through the base effect of generally low prices in 2010. Headline inflation peaked at 4.7% in August 2011, and has since dropped to just 2.6% in March 2012, helped by falling core inflation, which fell to 1.9%. Despite the drop in headline inflation, the recovery in commodity prices in early 2012 suggests inflationary pressures will remain a threat, with the key agricultural and oils index posting an average increase of 11.0% in 2011, and remaining high at 7.7% on the year in March. On balance, we expect continued moderation in the headline inflation rate at least for the first half of the year, though a pick up in the second half of the year may be likely.
- As growth moderated between 2010 and 2011, the focus of monetary policy has shifted away from normalisation of monetary conditions. The BOK halted its normalisation of interest rates in June 2011, coinciding with the peaking of headline inflation two months after and the build up to the Greek crisis in the latter half of the year. In all, the BOK raised its policy rate a total of 125 basis points (bps) to 3.25%. As evidence has built up regarding a slowdown in the external sector, Korean monetary policy remains on hold with a bias towards being accommodative towards growth. Risk factors and uncertainties prevail, although in the latest Monetary Policy statement (March 8 2012), the BOK thinks that the worst has passed and growth will begin returning to trend this year. On that basis, we may see a continuation of the normalisation process towards the end of the year.
- In line with the moderation in growth, total financing fell off from an average 7%-8% in 2010, to just above 5% in 2011. However, lending to households has bucked the trend, perhaps implying households are borrowing to maintain consumption. Breaking down the sources shows that borrowing is especially strong from non-bank depository institutions and through merchandise credit, with loans from both sources growing in the mid to high teens through both 2010 and 2011. At more than a quarter of household borrowing, this is a source of vulnerability for the financial system, as it is mostly uncollateralised. While the authorities are likely to be more proactive in heading off another household debt meltdown, the risk remains nascent, though we do not expect a larger implication to the stability of the banking system as a whole given current low default rates.
- Despite an increasingly challenging external environment, Korea has continued to record a healthy current account surplus, totalling USD26.5 billion (2010: USD29.4 billion), while its capital and financial account reported a larger deficit of USD32.0 billion (2010: -USD27.5 billion). International reserves rose to USD306.4 billion, reflecting the sustained trade surplus as well as the effort the BOK has put in to manage hot capital inflows. Import cover has declined however, falling to 7.0 times from 8.2 times at the end of 2010 and 10.0 times in December 2009, as growth in gross imports exceeded the pace of expansion in nominal exports in both 2010 and 2011. The external debt situation has stabilised in the aftermath of the Great Recession, with the resumption of growth and the recovery in the Korean Won's (KRW) value. As of 4Q2011, short term external debt has fallen to just 11.6% of GDP. Given the heavy reliance of banks on short term external funding, the paying down of short term external debt removes one critical source of vulnerability to macro-stability and reduces the consequences of sudden capital outflows.

- Both government revenue and expenditure are likely to miss the 2011 budget estimates on the low side, but the government has maintained a surplus for both 2010 and 2011. The overall balance improved slightly in 2011 to 1.5% of GDP from 1.4% of GDP with the debt outstanding equivalent to 32.6% of GDP. The government's external debt is small at 2.3% of total government debt and just 0.8% of GDP. We judge government finances to be in good shape, with sustainable debt ratios, solid revenue growth and a balanced budget.
- Comparing the critical macroeconomic matrices among selected Asian countries shows South Korea to be in a relatively favourable position along most dimensions with a budget surplus, sustainable debt ratios and a current account surplus. The main threat to headline economic growth is due to its low population growth which is barely above replacement level. This limits gains to output, especially considering Korea's ageing demographic profile. Other than that, Korea's record on governance remains solid, with the country in the top quartile of Transparency International's Corruption Perception Index.

## Introduction

South Korea, one of the world's most advanced industrial nations, is located in Eastern Asia along the Korea Strait with the Sea of Japan and the Yellow Sea as its natural borders. It is the 108<sup>th</sup> largest country in the world at 99,720 square kilometres, and, as part of a peninsula, has a considerable coastline of 2,413 kilometres. However, as the country comprises mostly hills and mountains with wide coastal plains in the west and south, only about 16.58% of the land is arable.

**Figure 1: The map of South Korea**



Source: CIA – The World Factbook

After existing as an independent country since its initial unification in the seventh century, Korea was declared a protectorate of Japan in 1905 following the Russo-Japanese war and subsequently annexed as a Japanese colony in 1910. Korea regained its independence at the end of World War II after Japan surrendered to the United States in 1945. After World War II, the Republic of Korea (ROK) was established in the southern section of the Korean Peninsula with President Syngman Rhee as the first president, while a Communist-style government was formed in the north under Kim Ji Sung. During the ensuing Korean War (1950-1953), troops from the United States and United Nations joined forces to defend the ROK from attacks from North Korea, which was supported by China and the Soviet Union. An armistice was eventually signed in 1953 that separated the peninsula along a demilitarised zone at about the 38<sup>th</sup> parallel, and to this day the war between north and south has not officially ended.

In the years following the armistice, South Korea underwent a period of political turmoil under autocratic leadership. President Syngman Rhee was forced to resign in April 1960 following a student-led uprising. The Second Republic, under the leadership of Chang Myon, was ended by a military coup led by Major General Park Chung-hee after only a year in power. Park's subsequent rule, which saw significant economic growth and development but curtailed political freedom, ended when he was assassinated in 1979. Subsequently, a strong group of military officers, led by Lieutenant General Chun Doo-hwan, declared martial law and wrested power.

The Park and Chun regimes saw a growing movement against authoritarian rule which peaked after Chun's military coup in 1979. Pro-democracy activities intensified, leaving the authorities no choice but to undertake political concessions in 1987 that included the restoration of direct presidential elections.

In 1987, Roh Tae-woo, a former general, was elected president; further democratic advances during his tenure led to the 1992 election of long-time pro-democracy activist Kim Young-sam, who became Korea's first civilian-elected president in over three decades. The 1997 presidential election and peaceful transition of power was a notable milestone in Korea's democratisation when Kim Dae-jung, a lifelong democracy and human-rights activist, was elected from a major opposition party. In 2002, self-educated human-rights lawyer Roh Moo-hyun won the presidential election on a "participatory government" platform, furthering the nation's transition to an open, democratic system. In December 2007, South Koreans elected former business executive and Seoul Mayor Lee Myung-bak as president.

South Korea has a population of 48,636,068 people as at July 2010, making it the 26<sup>th</sup> largest nation in the world. The 15-64 years age group makes up 72.3% of the population, and 97.9% of the population aged 15 and over can read and write. Korean is the national language, as the population is homogeneous (except for about 20,000 Chinese), while English is widely taught in junior high and high school.

Serious tensions with North Korea have strained inter-Korean relations in recent years. In 2010 alone, there were two hostile incidents where the North allegedly sank the South Korean warship Cheonan in March, and launched an artillery attack on South Korean soldiers and citizens in November.

### *The government and legal system*

Although South Korea is a republic with a separation of powers among the president, the legislature, and the courts, the locus of power is traditionally centred on the presidency. The president is chief of state and is elected for a single term of five years, while the 299 members of the National Assembly are elected for four-year terms. South Korea's judicial system comprises a Supreme Court, appellate courts, and a Constitutional Court, and the system's independence has been enshrined in the constitution, which was last revised in 1987.

The country has nine provinces and seven administratively distinct cities: the capital of Seoul, Busan, Daegu, Daejeon, Gwangju, Incheon and Ulsan. Political parties include the Grand National Party (GNP), Democratic Party (DP), Liberty Forward Party (LFP), New Progressive Party (NPP), Pro-Park Alliance (PPA), and Renewal Korea Party (RKP). The current President is Lee Myung-bak, while Kim Hwang-sik holds the post of Prime Minister, functioning as head of the government.

### *Economic background and structure*

South Korea's remarkable development over the past few decades has enabled it to rise from the economic shambles following the Korean war to become a member of the Organisation for Economic Cooperation and Development (OECD). Today, South Korea is the seventh-largest trading partner of the US and is also the 15<sup>th</sup>-largest economy in the world, no mean feat for a country with such humble roots.

In the early 1960s, the Park Chung-hee administration initiated sweeping economic policy changes that placed an emphasis on exports and labour-intensive light industries, leading to rapid debt-financed industrial expansion. The government also instituted currency reform, strengthened financial institutions and introduced flexible economic planning. In the 1970s, the nation began directing fiscal and financial policies toward promoting heavy and chemical industries, consumer electronics and automobiles. As such, manufacturing grew rapidly into the 1980s and early 1990s.

After the Asian Financial Crisis erupted in 1997/98, South Korea sought assistance from the International Monetary Fund (IMF) and quickly recovered from the crisis, with its recovery stemming primarily from the extensive financial reforms that helped restore stability to markets. Indeed, growth rates were remarkable in subsequent years - 10% in 1999 and 9% in 2000. The global economy weakened in 2001 after the September 11 terrorist attacks in the US, causing South Korean export growth to slow to 3.3%. This prompted the government to introduce stimulus measures that brought about 7.0% growth in the following year. However, overspending by consumers and the consequent rise in household debt, along with other external factors, dampened growth in 2003. Economic performance in the year after improved to a healthy 4.6% due to an expansion in exports, and remained at or above

4% until the onset of the global financial and economic crisis, when annual GDP growth slowed to 2.3% in 2008 and just 0.3% in 2009.

The economy's strong point is concentration on industry: As of 2011, services makes up the larger part of the economy with a 58.0% share of GDP, while manufacturing comprises 31.2%. Of the other sectors, only construction is significant at 5.9%, with agriculture, forestry and fishing (2.7%), mining and quarrying (0.2%), and electricity, gas and water supply (2.0%) form the remainder of the economy. While the presence of an educated workforce and export-oriented manufacturing has enabled the South Korean secondary sector to lead the country into becoming a high-income, advanced economy with a developed market, the services sector has become increasingly important, which is common among advanced economies.

South Korean companies have grown in stature to become reputable global brands. In 2011, South Korean shipyards are expected to be at the pole position in the global shipbuilding industry due to competitive design skill, abundant skilled labour and technological advancements. Indeed, shipping is a major cornerstone of the South Korean economy, with four main shipyards leading the way: Hyundai Heavy Industries, Samsung Heavy Industries, Daewoo Shipbuilding and Marine Engineering, and the newest in line, STX Shipbuilding. The largest and most successful of the shipyards, Hyundai Heavy Industries, is also the largest shipbuilder in the world, building a full 10 percent of all ships manufactured in the world as at October 2010. Hyundai-Kia, the country's automobile manufacturer, also owns the distinction of being fourth-largest in the world, while the country is home to three of the world's largest oil refineries. In the sphere of consumer technology, the country is the largest manufacturer of television displays, and Samsung and LG are among the world's top three television and mobile-phone manufacturers.

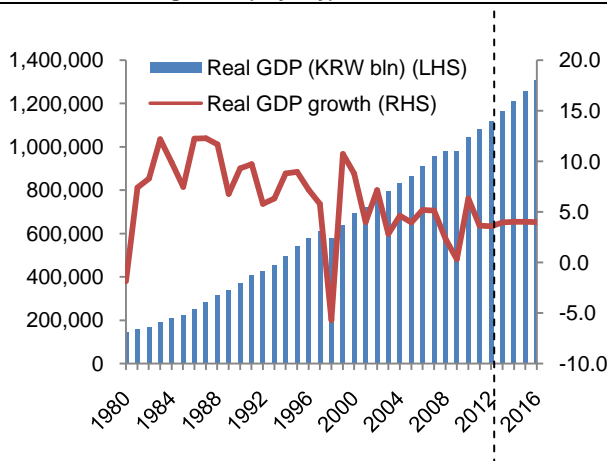
However, the country's rapidly ageing population and structural problems such as the rigidity of labour regulations, the need for more constructive relations between management and workers, the country's underdeveloped financial markets, and a general lack of regulatory transparency presently detract from the nation's growth potential.

## The economy in detail

### Growth momentum slowing

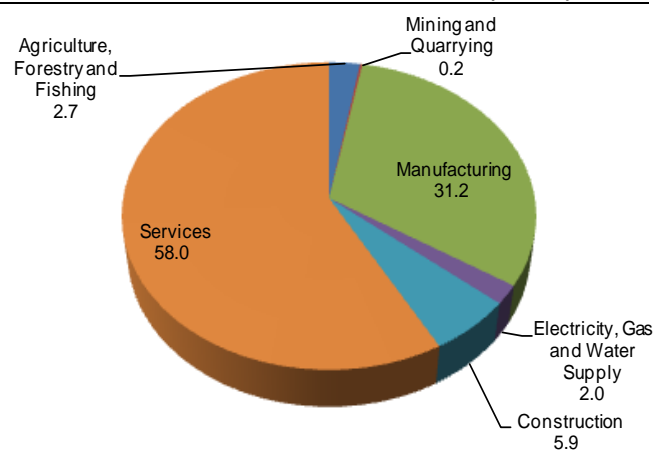
Growth in 2011 slowed from the recovery year of 2010, with a 3.6% showing compared to 6.3% growth in 2010. Economic activity slowed throughout the year, with GDP growth dropping from 4.2% in 1Q2011 to 3.3% in 4Q2011. On a seasonally adjusted annualised rate (SAAR), quarterly growth dropped from 5.3% in 1Q2011 to just 1.3% in 4Q2011.

Chart 1: Real GDP growth (% y-o-y)



Source: IMF World Economic Outlook  
Note: 2012-16 GDP are forecast figures

Chart 2: South Korean economic structure 2011 (% GDP)



Source: Bank of Korea

The drop in economic activity was actually worse than revealed by the headline growth numbers, as negative quarterly growth was recorded across all expenditure categories, except for inventories. Somewhat ironically given the source, the external sector provided some nominal support to output growth, but mainly through a sharper drop in imports compared to exports. For the year, both private and public consumption showed moderating growth, dropping to 2.3% and 2.1% in 2011 from 4.4% and 2.9% in 2010 respectively.

Investment formed the biggest drag to growth on the demand side, with gross fixed capital formation contracting 1.1% after posting a growth of 5.8% in 2010. Much of the drop in investment came from lower construction activities, which posted y-o-y contractions in every quarter of 2011, but particularly in 1Q2011 when construction activities dropped 11.0% over the year before and 16.4% annualised from 4Q2010. For the year as a whole, construction investment contracted by 5.0%.

On the supply side, the locus of the Korean economy remains manufacturing, where growth also slowed throughout the year, dropping from 10.0% on the year in 1Q2011 to 5.4% in 4Q2011 – for the year as a whole, the manufacturing sector grew by a still impressive 7.2% rate despite slower than the 14.7% growth posted in 2010. The only other significant sector showing above average growth was wholesale & retail trade, which posted 4.6% growth for the year.

Going forward, we expect growth prospects to be challenging this year on the back of recession in Europe and slowing growth in China, which together take in nearly a third of Korea's exports. In its latest Economic Outlook, the BOK is forecasting GDP growth for 2012 to slow to 3.5% before recovering to 4.2% in 2013, with the advance estimate for 1Q2012 at 2.8%. We estimate Korea's trend growth for the last ten years to be about 4.3%. We believe growth has probably bottomed out in 1Q2012 before recovering as better prospects in the US and potential policy easing in China pave the way for stronger global growth. However, while we think Korea may potentially post better growth numbers than in 2011, above trend growth isn't likely to be on the cards.

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

	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11	4Q11	1Q12
Gross Domestic Product	7.6	4.5	4.9	4.2	3.5	3.6	3.3	2.8
By Expenditure								
Final consumption expenditure (Private)	3.6	3.5	3.0	2.6	2.7	2.3	1.3	2.2
(Government)	3.9	3.9	3.0	2.9	3.0	2.1	1.1	1.6
Gross fixed capital formation (Facilities investment)	2.8	2.4	3.2	1.4	1.8	3.3	1.6	4.4
(Construction)	5.8	5.6	2.3	-2.1	0.7	-1.5	-1.8	5.1
Exports of goods and services	32.0	26.3	16.9	10.3	7.7	1.2	-3.3	2.1
Imports of goods and services	-4.7	-4.9	-5.2	-11.0	-4.2	-4.0	-2.1	9.1
By industry								
Agriculture, forestry and fishing	15.1	11.8	16.0	17.0	8.5	9.6	4.4	5.0
Manufacturing	18.1	14.7	14.8	10.8	7.9	6.2	1.6	4.6
Electricity, gas & water supply	-2.2	-7.8	-5.9	-7.9	-1.9	-4.1	3.7	2.1
Construction	17.6	9.5	11.0	10.0	7.5	6.3	5.4	4.2
Services	5.5	3.1	6.0	3.0	2.4	0.7	5.7	1.0
	-2.1	-2.0	-4.7	-9.6	-7.1	-2.7	-0.6	3.0
	4.1	3.2	3.5	2.9	2.7	2.6	2.5	2.3

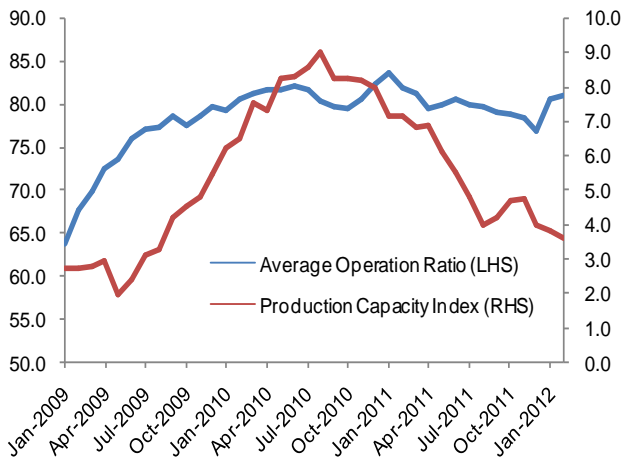
Source: CEIC, BOK

### *Inflation has peaked*

In line with the rest of the region, Korea's inflation rate has begun to moderate as commodity prices have come off market highs and through the base effect of generally low prices in 2010. Headline inflation peaked at 4.7% in August 2011, and has since dropped to just 2.6% in March 2012, helped by falling core inflation, which fell to 1.8%. Acceleration in producer prices has also slowed considerably, falling to 2.8% in March, helped by slowing price increases in manufacturing products and more rapid depreciation in electronic component products. Despite the drop in headline inflation, the recovery in commodity prices in early 2012 suggests inflationary pressures will remain a threat, with the key agricultural and oils index posting an average increase of 11.0% in 2011, and remaining high at 7.7% on the year in March – monthly gains in 2012 have posted a blistering 2.4% pace.

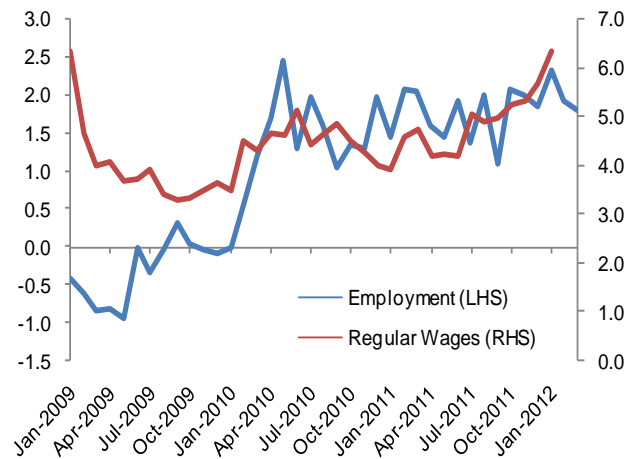
Demand factors will also contribute to inflationary pressure in the year ahead, with manufacturing average operation ratio having recovered to over 80% in January-February 2012, and additions to production capacity having stalled over the last quarter. Job creation remains robust, with the employed labour force increasing a seasonally adjusted 2.0% monthly average 1Q2012, although wage growth has stagnated in recent months. On balance, we expect continued moderation in the headline inflation rate at least for the first half of the year, though a pick up in the second half of the year may be likely.

**Chart 3: Average operation ratio and production capacity growth (% y-o-y)**



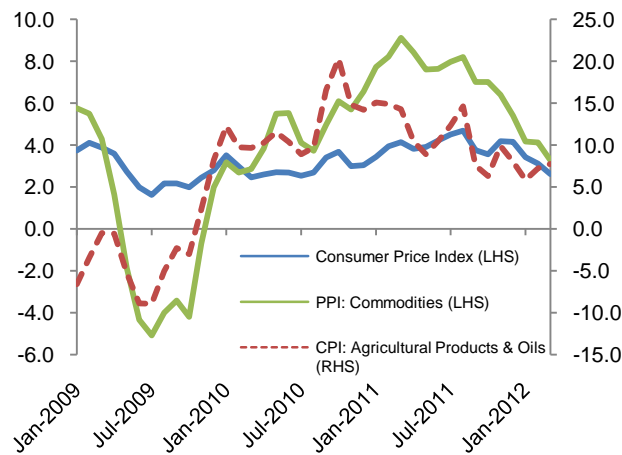
Source: CEIC

**Chart 4: Employed persons – all industries and wage growth (% y-o-y)**



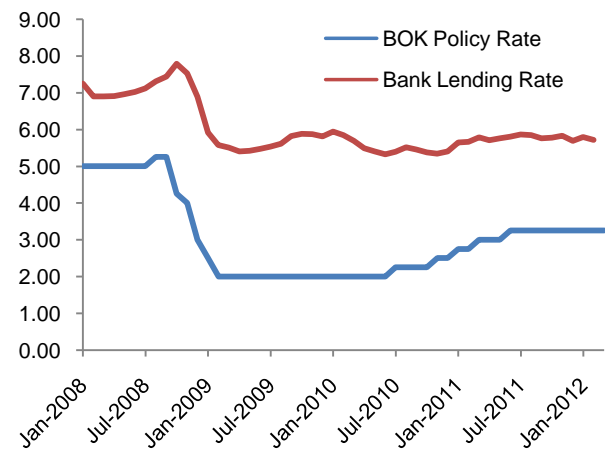
Source: CEIC

**Chart 5: Consumer and producer price indexes (% y-o-y)**



Source: CEIC

**Chart 6: BOK policy rate and average commercial bank lending rate (%)**



Source: CEIC

**Monetary policy on hold**

As growth moderated between 2010 and 2011, the focus of monetary policy has shifted away from normalisation of monetary conditions. The BOK halted its normalisation of interest rates in June 2011, coinciding with the peaking of headline inflation two months after and the build up to the Greek crisis in the latter half of the year. In all, the BOK raised its policy rate a total of 125 bps to 3.25%. Nevertheless, the BOK has substantially withdrawn the liquidity support it provided to the domestic banking system, with just a quarter of the KRW28 trillion extended in 2009 remaining as at the end of 3Q2011.

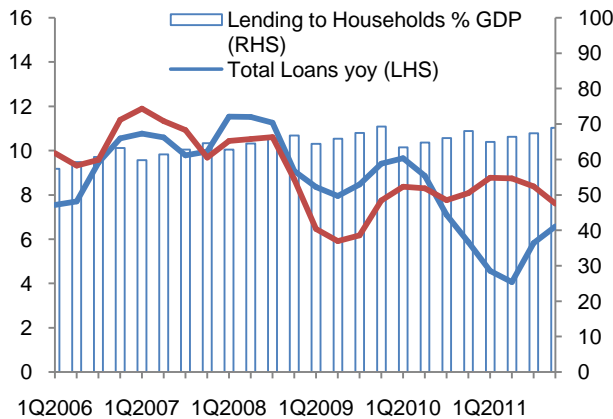


As evidence has built up regarding a slowdown in the external sector, Korean monetary policy remains on hold with a bias towards being accommodative towards growth. Risk factors and uncertainties prevail, although in the latest Monetary Policy statement (March 8 2012), the BOK thinks that the worst has passed and growth will begin returning to trend this year. On that basis, we may see a continuation of the normalisation process later in the year.

**Bank lending and household borrowing**

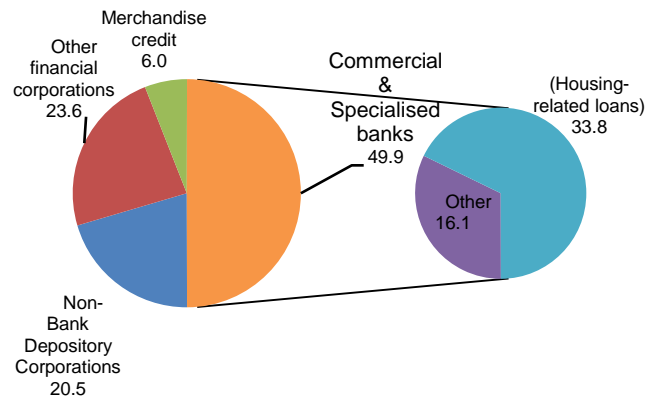
In line with the moderation in growth, total financing fell off from an average 7%-8% in 2010, to just above 5% in 2011. However, lending to households has bucked the trend, perhaps implying households are borrowing to maintain consumption. Breaking down the sources shows that borrowing is especially strong from non-bank depository institutions and through merchandise credit, with loans from both sources growing in the mid to high teens through both 2010 and 2011. At more than a quarter of household borrowing, this is a source of vulnerability for the financial system, as it is mostly uncollateralised. South Korea has already had a history of overextended consumer borrowing, leading to a mini-crisis in the early-2000s. While the authorities are likely to be more proactive in heading off another household debt meltdown the risk remains nascent, though we do not expect a larger implication to the stability of the banking system as a whole given current low default rates.

**Chart 7: Total loans and household lending (% y-o-y)**



Source: Bank of Korea

**Chart 8: Sources of lending to households % total lending**



Source: Bank of Korea

**Balance of payments and official reserves**

Despite an increasingly challenging external environment, Korea has continued to record a healthy current account surplus, totaling USD26.5 billion (2010: USD29.4 billion), while its capital and financial account reported a larger deficit of USD32.0 billion (2010: -USD27.5 billion). International reserves rose to USD306.4 billion, reflecting the sustained trade surplus as well as the effort the BOK has put in to manage hot capital inflows. Import cover has declined however, falling to an average 7.0 times from 8.2 times in 2010 and 10.0 times in 2009, as growth in gross imports exceeded the pace of expansion in nominal exports in both 2010 and 2011.

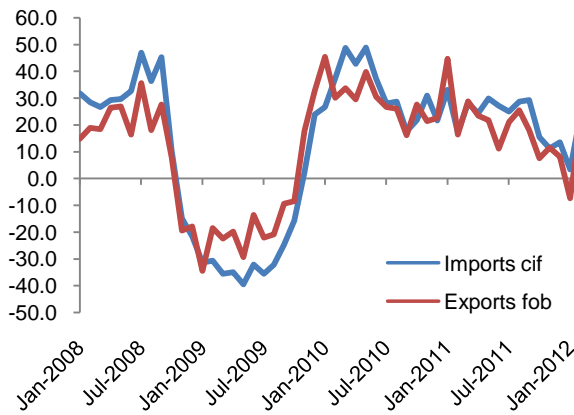
After the hammering taken in the 2H2008, the KRW has stabilised and recovered its value against the USD and the EUR. However, it remains substantially depressed against the CNY and JPY. Hot money outflows remain a threat to the country's financial stability, especially in view of the reliance of the banking system on short term wholesale financing. We see further reserve accumulation likely, both to ameliorate excess liquidity in the banking system as well as "insurance" against capital outflows, and this will likely dampen any upside for the KRW over the near future.

**Table 2: Balance of payments (USD million)**

	2006	2007	2008	2009	2010	2011
Current Account	14,083	21,770	3,198	32,791	29,394	26,505
Goods	31,433	37,129	5,170	37,866	40,083	30,950
Services	(13,332)	(11,967)	(5,734)	(6,641)	(8,626)	(4,377)
Primary Income	75	135	4,435	2,277	1,016	2,456
Secondary income	(4,093)	(3,527)	(674)	(712)	(3,079)	(2,523)
Capital and Financial Account	(14,151)	(23,877)	(1,154)	(34,651)	(27,479)	(31,965)
Capital Account	(3,126)	(2,388)	109	290	(218)	150
Financial Account	(11,025)	(21,489)	(1,263)	(34,941)	(27,261)	(32,115)
Net Errors and Omissions	68	2,107	(2,044)	1,861	(1,915)	5,459

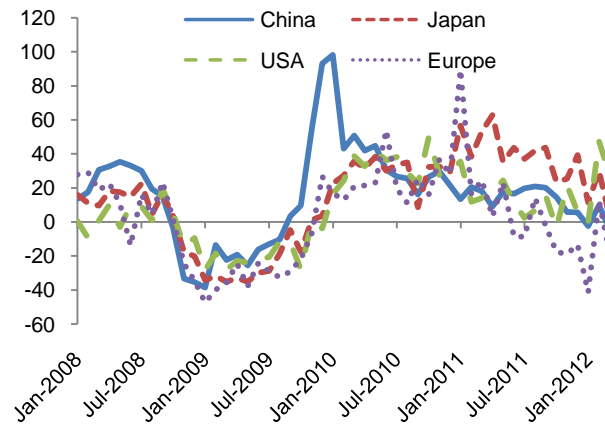
Source: CEIC

**Chart 9: Exports and imports (% y-o-y)**



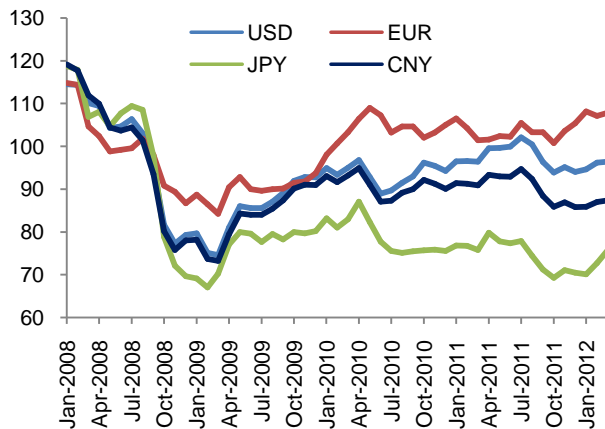
Source: CEIC

**Chart 10: Exports to major trade partners (% y-o-y)**



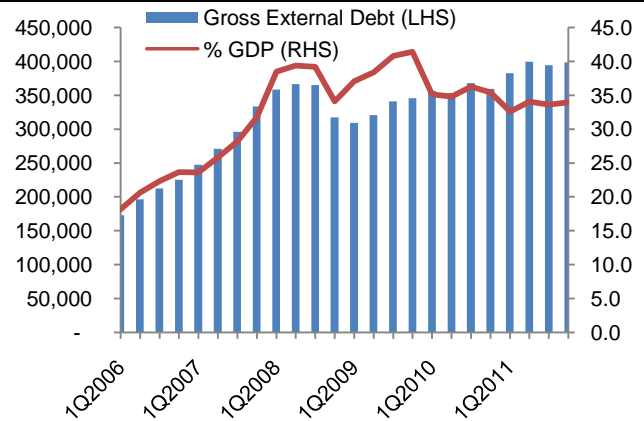
Source: CEIC

**Chart 11: KRW major exchange rates (index, 2008=100)**



Source: MARC Economic Research

**Chart 12: Gross external debt (KRW bil) and ratio to GDP (%)**



Source: BOK

The external debt situation has stabilised in the aftermath of the Great Recession, with the resumption of growth and the recovery in the KRW's value. Prior to 2008, gross external debt was on an unsustainable growth trajectory, rising 48.1% in 2007 alone, and a further 23.4% yoy up to the 3Q2008. By 2011 however, growth in external debt moderated to 10.8% y-o-y. Short term debt has risen even faster, peaking at 20.4% of the total in 3Q2008, before falling sharply in the recession, and slowly

declining afterwards. As of 4Q2011, short term external debt has fallen to just 11.6% of GDP. Given the heavy reliance of banks on short term external funding, the paying down of short term external debt removes one critical source of vulnerability to macro-stability and reduces the consequences of sudden capital outflows.

### Government operations and debt

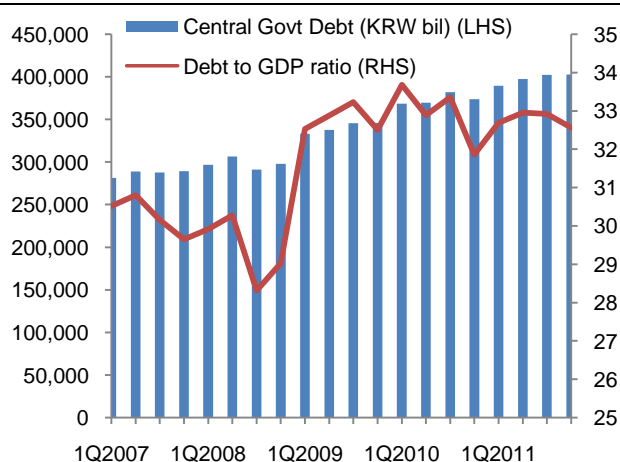
Both government revenue and expenditure are likely to miss the 2011 budget estimates on the low side, but the government has maintained a surplus for both 2010 and 2011. The overall balance improved slightly in 2011 to 1.5% of GDP from 1.4% of GDP with the debt outstanding equivalent to 32.6% of GDP. The government's external debt is small at 2.8% of total government debt and just 0.9% of GDP. Revenue growth has averaged a steady 7.4% over the past decade, marginally faster than nominal GDP growth, such that the government's effective tax yield from the economy has risen to an average of 23.9% of nominal GDP over the past five years (2007-2011) from 22.2% in the five years preceding that (2002-2006). We judge government finances to be in good shape, with sustainable debt ratios, solid revenue growth and a balanced budget.

**Table 3: Central government finances (KRW billion)**

	2007	2008	2009	2010	2011
Total Revenue	243,633	250,713	255,252	270,923	292,312
Total expenditure and lending	209,810	238,834	272,873	254,231	273,694
Overall balance	33,823	11,880	(17,620)	16,692	18,618
Overall balance (% GDP)	3.5	1.2	(1.7)	1.4	1.5
Government debt (% GDP)	29.7	29.0	32.5	31.9	32.6

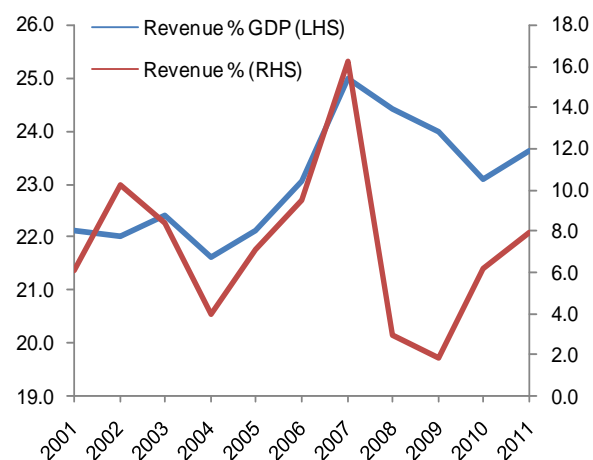
Source: CEIC

**Chart 13: Central government debt and Debt to GDP ratio (%)**



Source: Bank of Korea

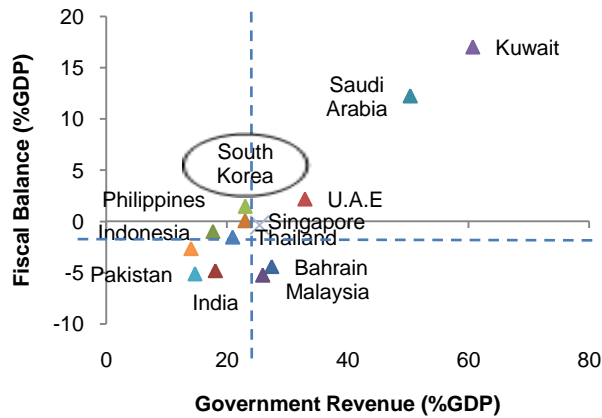
**Chart 14: Government revenue growth (% y-o-y) and ratio to GDP (%)**



Source: Bank of Korea

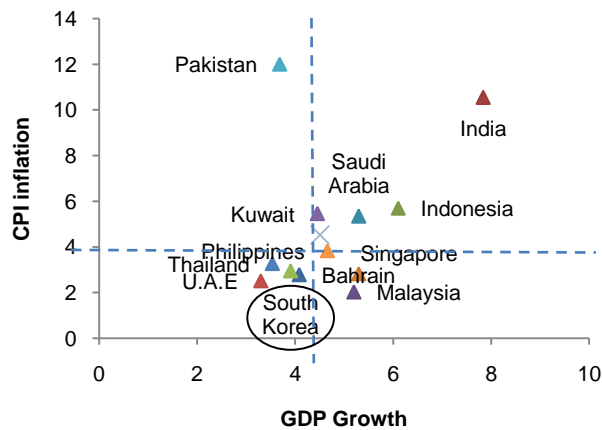
Comparison of five-year median macroeconomic matrices

Chart 15: Government revenue vs. Fiscal balance



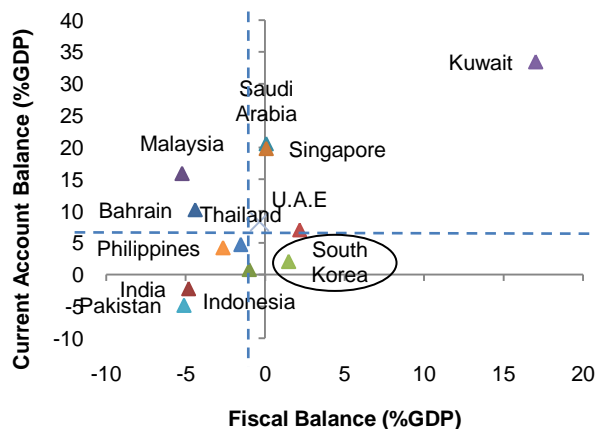
Sources: IMF & MARC Economic Research

Chart 16: CPI & GDP growth



Sources: IMF & MARC Economic Research

Chart 17: Current account % of GDP vs. fiscal balance % of GDP



Sources: IMF & MARC Economic Research

- In the revenue against fiscal balance matrix, South Korea resides in a relatively favourable quadrant, with a positive fiscal balance and revenue yield just below the average 5 year median of the countries under our coverage.

- The government has considerable latitude for fiscal action in support of the economy, but has chosen to maintain a more moderate approach with a view towards maintaining medium term fiscal sustainability.

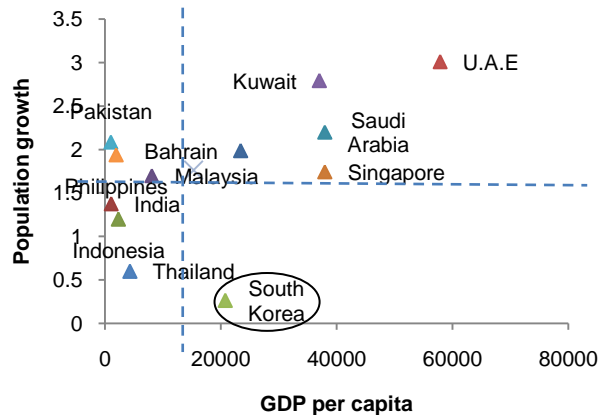
- South Korea has a relatively low inflation rate despite being highly exposed to price fluctuations of primary commodities and the occasional high volatility of its exchange rate.

- Low in natural resources, Korea has nevertheless sustained a growth rate near the average 5 year median of our sample. The future challenge is to maintain this growth rate in the face of a falling population growth rate and a rapidly ageing demographic.

- In the current account fiscal balance matrix, South Korea is in the relatively favourable quadrant with both a current account surplus as well as a fiscal surplus.

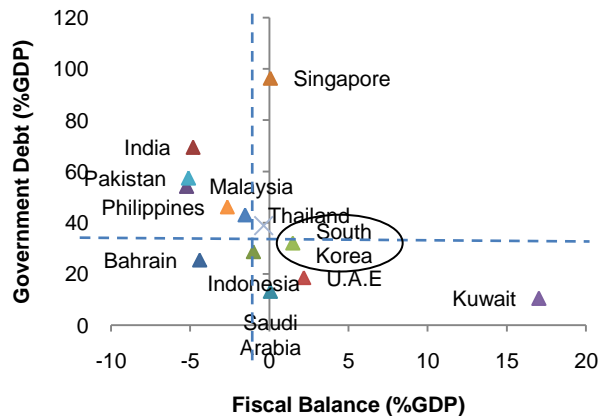
- By definition, this suggests that the economy is either running below potential or exporting capital, and domestic growth could probably be boosted by higher private or public consumption. Nevertheless, from a fiscal sustainability perspective, South Korea is well placed; and the gap between Korea's position and the point of external and internal balance remains small. This suggests that output gap is probably fairly small.

Chart 18: Population growth vs. GDP per capita



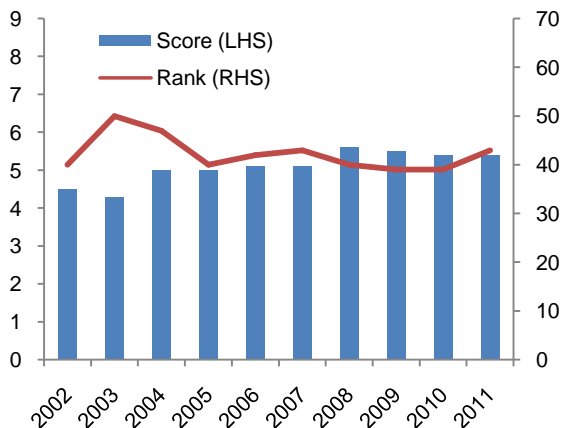
Sources: IMF & MARC Economic Research

Chart 19: Govt. debt % of GDP vs. fiscal balance % of GDP



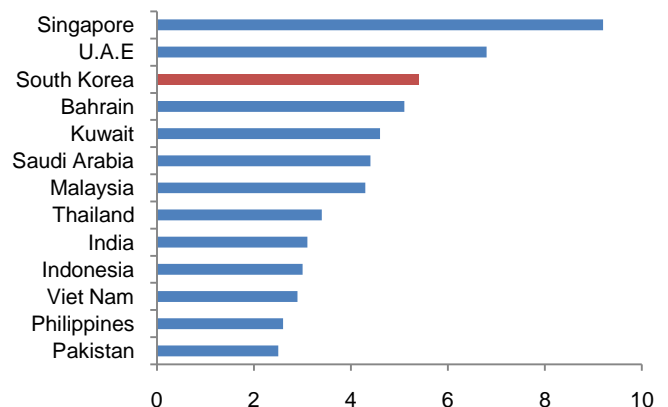
Sources: IMF & MARC Economic Research

Chart 20: Corruption Perception Index



Source: Transparency International

Chart 21: Corruption perception index (the higher the better)



Source: World Bank

Korea's corruption statistics remain stable, with slow and steady improvement in the index scores over the past decade and remains among the highest within our sample of countries. Based on the Corruption Perception Index by Transparency International, the overall perception score of corruption in Korea has consistently remained above 5.0 since 2004 (the higher the better) and hit a high of 5.6 just before the onset of the Great Recession. The country's ranking in 2011 remains in the top quartile, at 43 out of 183 countries.

**Table 4: Summary of Macro Matrices**

<b>Matrix</b>	<b>Explanation</b>
<b>Government revenue and fiscal balance</b>	South Korea is located in the second-best quadrant and is better placed than most of the countries covered, due to a budget surplus and revenue to GDP around the median level.
<b>CPI and real GDP growth</b>	South Korea is located in a relatively unfavourable position here, with slowing growth which is offset by low inflation. However, the country is not too far off from being in the best quadrant by virtue of growth not much below the average median level.
<b>Current account and fiscal balance</b>	Korea is in the relatively favourable quadrant, running both a current account surplus and a fiscal surplus.
<b>GDP per capita and population growth</b>	Although South Korea has high GDP per capita, population growth is too low and can be a source of fiscal instability in the future.
<b>Fiscal balance and government debt</b>	South Korea lies in the most favourable quadrant, with a budget surplus and low government debt.
<b>Control of corruption</b>	South Korea ranks favourably with an improving record of governance

## Appendix

## Vital statistics - Korea

	2006	2007	2008	2009	2010	2011	2012F
<b>National accounts</b>							
<b>Growth (%)</b>							
GDP	5.2%	5.1%	2.3%	0.3%	6.3%	3.6%	3.5%
<b>Supply side</b>							
Agriculture, forestry & fishing	1.5%	4.0%	5.6%	3.2%	-4.4%	-2.0%	n.a.
Mining & quarrying	-0.1%	-4.1%	0.6%	-0.8%	-8.6%	-4.6%	n.a.
Manufacturing	8.1%	7.2%	2.9%	-1.5%	14.7%	7.2%	n.a.
Construction	2.2%	2.6%	-2.5%	1.8%	-2.7%	-4.6%	n.a.
Services	4.4%	5.1%	2.8%	1.2%	3.9%	2.7%	n.a.
<b>Demand side</b>							
Total final consumption expenditure	5.1%	5.1%	2.0%	1.2%	4.1%	2.2%	n.a.
-Private final consumption expenditure	4.7%	5.1%	1.3%	0.0%	4.4%	2.3%	n.a.
-Government final consumption expenditure	6.6%	5.4%	4.3%	5.6%	2.9%	2.1%	n.a.
Gross fixed capital formation	3.4%	4.2%	-1.9%	-1.0%	5.8%	-1.1%	n.a.
Exports	11.4%	12.6%	6.6%	-1.2%	14.7%	9.5%	6.6%
Imports	11.3%	11.7%	4.4%	-8.0%	17.3%	6.5%	3.9%
<b>Public finance (% of GDP) - Central government</b>							
<b>Total receipts</b>	<b>23.1%</b>	<b>25.0%</b>	<b>24.4%</b>	<b>23.5%</b>	<b>23.1%</b>	<b>23.6%</b>	<b>22.8%</b>
-Tax revenue	15.2%	16.6%	16.3%	15.4%	15.2%	n.a.	n.a.
-Non tax revenue	7.9%	8.4%	8.1%	8.1%	7.9%	n.a.	n.a.
<b>Total expenditure</b>	<b>22.4%</b>	<b>21.2%</b>	<b>22.9%</b>	<b>25.2%</b>	<b>21.7%</b>	<b>22.1%</b>	<b>20.4%</b>
<b>Fiscal balance</b>	<b>0.7%</b>	<b>3.8%</b>	<b>1.5%</b>	<b>-1.7%</b>	<b>1.4%</b>	<b>1.5%</b>	<b>2.4%</b>
<b>Inflation rate</b>							
Producer Price Index (WPI)	0.9%	1.4%	8.6%	-0.2%	3.8%	6.1%	n.a.
Consumer Price Index (CPI)	2.2%	2.5%	4.7%	2.8%	2.9%	4.0%	3.4%
<b>Money, banking and policy rates</b>							
M1 growth	10.4%	-12.5%	5.2%	16.4%	12.9%	1.6%	n.a.
M2 growth	11.4%	11.5%	13.1%	9.3%	7.2%	4.4%	n.a.
Bank credit growth (commercial and specialised banks)	13.9%	14.9%	14.1%	4.0%	3.5%	7.7%	n.a.
loan-to-deposit ratio (commercial and specialised banks)	100.4%	108.7%	111.4%	107.8%	104.1%	111.1%	n.a.
NPL Ratio (commercial and specialised banks)	0.7%	0.6%	0.9%	0.8%	1.1%	0.9%	n.a.
Base Rate	4.50%	5.00%	3.00%	2.00%	2.50%	3.25%	n.a.
Reserve Ratio (Time Deposits/Demand Deposits)	2%/7%	2%/7%	2%/7%	2%/7%	2%/7%	2%/7%	n.a.
<b>Balance of payments (% of GDP)</b>							
Current account	1.5%	2.1%	0.3%	3.9%	2.9%	2.4%	n.a.
Capital & financial account	-1.2%	-2.0%	-0.1%	-4.2%	-2.7%	-2.9%	n.a.
Overall balance	0.0%	-0.2%	0.2%	-0.2%	0.2%	-0.5%	n.a.
International reserves (USD bn)	239.0	262.2	201.2	270.0	291.6	306.4	n.a.
Reserve-to-import (x)	9.3	8.8	5.5	10.0	8.2	7.0	n.a.
External debt - USD bn	225.2	333.4	317.4	345.7	359.4	398.4	n.a.
External debt - % of GDP	23.7%	31.8%	34.1%	41.4%	35.4%	34.0%	n.a.
Debt service ratio (% Reserves)	40.1	58.5	104.3	72.5	65.1	54.4	n.a.
<b>Development indicators</b>							
Population (in mn)	48.3	48.5	48.6	48.7	48.9	49.0	49.1
Population (growth)	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%
Human Development Index (HDI) - Very high human dev.	<u>1990</u> 0.742	<u>2000</u> 0.830	<u>2005</u> 0.866	<u>2009</u> 0.889	<u>2010</u> 0.894	<u>2011</u> 0.897	n.a.

Sources: CEIC, IMF, BOK, Rabobank, EIU, UNDP, MARC Economic Research

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