

# Economic Research

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## Country Outlook: South Korea



**MALAYSIAN RATING CORPORATION BERHAD**  
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the last page of this report*

## In a nutshell

- **Green shoots:** The latest data suggests growth may be picking up again. Headline gross domestic product (GDP) expanded by 2.3% in 2Q2013, helped by accelerating growth in government spending and exports. More pertinently, investment expanded for the first time since 2Q2012, albeit at a fairly weak 2.5%. On the supply side, manufacturing growth remains weak at 2.0%, which questions the sustainability of the economy's growth recovery, especially since growth in the services sector is poorer at an average of 2.1% for 1H2013 compared to an overall 2.5% growth in 2012. Nevertheless, a boost in construction output offers some grounds for optimism, as it signals stronger business confidence in the economy, which is somewhat confirmed by business surveys.
- We expect growth prospects to remain challenging this year even as Europe's recession appears to be over and the United States (US) and Japan register stronger growths. The latest Bank of Korea (BoK) forecast has GDP growth accelerating to 3.5% for 2H2013, bringing full year GDP growth to 2.8%, with the main drivers of growth being construction investment and higher trade activities. The forecast for 2014 on the other hand stands at 4.0%. These numbers remain below our estimate for Korea's trend growth at 4.3%. Given the weakness of growth in advanced economies and the slow deterioration in China's growth momentum, we think that the risks to the forecast are pretty high, and may be subject to considerable revision as circumstances dictate.
- **Inflation is subdued:** The latest data confirms subdued price pressures, although consumer price index (CPI) inflation rose to 1.4% year-on-year (y-o-y) in July 2013 (Core inflation: 1.5%) compared to just 1.0% in June (Core: 1.4%). Much of the July increase in inflation comes from higher prices for food and transport, with contributions from agricultural products and recreation prices. Looking deeper however, prices in July were in aggregate not much higher than in January, as the Korean economy suffered price deflation in the period February-June 2013. Recent increases in global crude oil prices suggest that inflation may accelerate in the second half of the year, although we believe headline inflation should still come in below 2.0% by December.
- **Monetary policy is accommodative:** M1 growth has recovered dramatically since 1H2012, climbing to 11.8% in June 2013, although growth in the broader-based M2 aggregate, which better proxies economic activity, remains poor at 4.9% in June (June 2012: 6.5%). M2 components related to short-term commercial deposits are contracting and bank deposit growth in 1H2013 is nearly half the level of the year before at an average 3.7% versus 7.2% in 1H2012. Overall loan growth is similarly weak, with growth averaging 3.3% in 1H2013 compared to 6.1% in 1H2012. We foresee a pick-up in loan activity (and thus M2) going into the second half of the year, as BoK's rate cuts take hold and from an expected improvement in the business environment. After having brought the policy rate back down to within 50 basis points (bps) of its level at the Great Recession, we believe BoK will likely pause to take stock of the situation before committing to further monetary easing.
- **Current account in surplus and reserves continue to accumulate:** For 1H2013, the current account surplus has continued to expand strongly, more than doubling the total from the same period last year. The higher surplus was driven by a stronger trade surplus (1H2013: 126.1% y-o-y) counterbalanced by an equally strong inflow of capital. Fund inflows via the capital and financial account were 221.2% higher than in 1H2012, which were in turn 228.2% higher than in 1H2011. Inflows from both these sources have contributed to rising international reserves, although BoK has not appeared to be intervening heavily in forex markets, opting instead to bolster its gold holdings. After strengthening through most of 2H2012, the Korean won (KRW) has weakened against both the US dollar (USD) and against a broader slate of currencies, losing about 7% against the USD between December 2012 and June 2013, although a strong 3.2% recovery was posted in June. However, we do not see the KRW deviating too much from these levels against other regional currencies, although the USD outlook is clouded by prospects of monetary stimulus withdrawals by the US Federal Reserve.
- **External debt situation improving:** The external debt situation has continued to improve, with overall growth in external liabilities falling 0.3% in 1Q2013 from a year before. Short-term external debt has

actually contracted, recording 9 contractions in the last ten quarters to 1Q2013. The debt profile has shifted to a less risky composition, with a greater portion from non-banks and for longer maturities. Banking system exposure has also improved, with the portion of long-term liabilities (which are less volatile) rising from 34.8% at end of 2008 to 53.3% at the end 2012.

- **Government fiscal position is weakening, but still solid:** As growth has slowed going into 2012, the government's fiscal balance has also worsened. Up to 1Q2013, revenue is 11.1% below the level in the same period of 2012. The central government has responded by cutting expenditure but not to the same extent, with the result that the overall balance is in deficit to the tune of KRW14.8 trillion for 1Q2013 (or 1.2% of GDP). In addition, the government tabled a supplementary budget worth KRW17.3 trillion (or about 1.3% of GDP) in April 2013 to address job growth and still-weak investment, which is expected to boost growth by 0.3% and create 40,000 jobs. With both revenue shortfalls and additional fiscal stimulus, the government debt position is expected to worsen slightly to 36.2% of GDP.
- **Macroeconomic matrices:** Against our previous annual review, South Korea's position in the macroeconomic matrices has worsened somewhat, but not to any great degree. In fact, South Korea lies at or near the average of numbers of the countries under our coverage, with the exception being in GDP per capita (higher) and population growth and inflation (lower).

## 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 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 US in 1945. The Republic of Korea (ROK) was established in the south of the Korean Peninsula with 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 US and United Nations joined forces to defend the ROK from North Korean attacks, which was supported by China and the Soviet Union. An armistice that separated the peninsula along a still-enforced demilitarised zone was eventually signed in 1953 at about the 38<sup>th</sup> parallel. Tensions with North Korea have waxed and waned over the years; which have sometimes resulted in shooting incidents, but a resumption of the war has thus far been avoided.

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 ended in 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 became 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's population hit 50 million in 2012, making it the 26<sup>th</sup> largest nation in the world in terms of population. 72.3% of the population is aged between 15-64 years, and 97.9% of the population aged 15 and over can read and write. Korean is the national language in this largely homogeneous population, although English is widely taught in junior high and high school.

### *The government and legal system*

Although South Korea is a republic with a theoretical separation of powers between the president, the legislature, and the courts, the locus of power has 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. Korea has a diverse political party landscape, but the legislature is currently dominated by the conservative Saenuri Party and the left-leaning Democratic United Party. The current President is Park Geun-hye from the Saenuri Party, who was elected in February 2013, while Jung Hong-won (also with Saenuri) 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 in 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 - 10.0% in 1999 and 9.0% 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 4.0% until the onset of the global financial and economic crisis (the Great Recession), 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 2012, services make up the larger part of the economy with a 57.4% share of GDP, while manufacturing comprises 31.7%. Of the other sectors, only construction is significant at 5.7%; with agriculture, forestry and fishing (2.8%), mining and quarrying (0.2%), and electricity, gas and water supply (2.3%) forming the remainder of the economy. While the presence of an

educated workforce and an emphasis on export-oriented manufacturing has led Korea's economic growth, the services sector has become increasingly important as is common among advanced economies.

South Korean companies have grown in stature to become reputable global brands. South Korean shipyards, for example, lead 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, mirroring Japan's also successful rebuilding after World War II. The largest and most successful of the shipyards, Hyundai Heavy Industries, is also the largest shipbuilder in the world. Hyundai-Kia, the country's largest automobile manufacturer, also has the distinction of being the second-largest in Asia and the fourth-largest in the world. Korea is also home to three of the world's largest oil refineries and in the sphere of consumer technology, the country is the largest manufacturer of television displays. Samsung and LG are among the world's top three television and mobile-phone manufacturers.

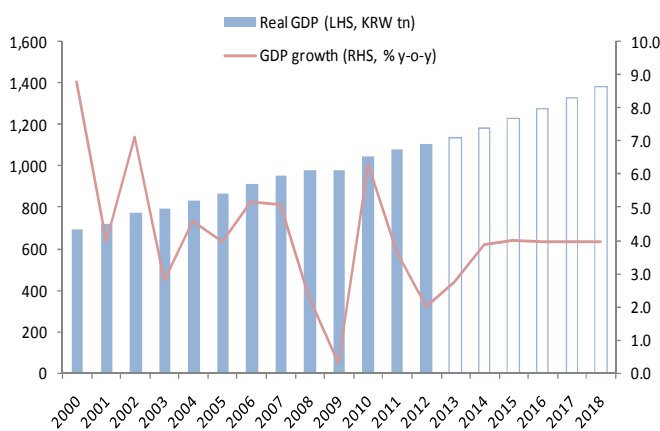
While Korea has been an enviable model of development success, the country's rapidly ageing population and structural problems such as rigid labour regulations, the need for more constructive relations between management and workers, the country's underdeveloped financial markets, and a general lack of regulatory transparency presently detract from the nation's growth potential.

## The economy in detail

### Green shoots...

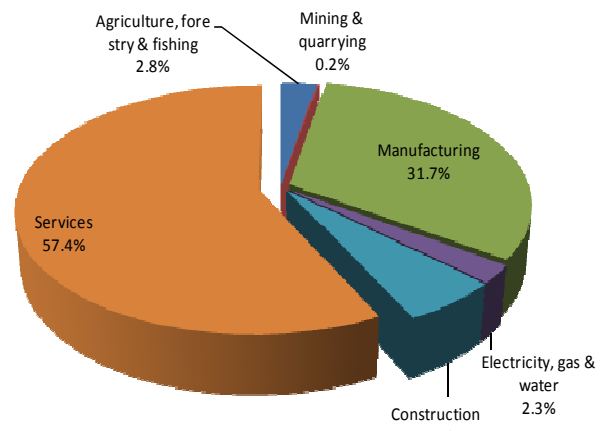
Following the post-Great Recession recovery, growth in South Korea moderated to just 2.0% overall in 2012, with headline numbers dropping throughout the year. By comparison, pre-crisis growth had averaged over 5.0% per year. The pullback in growth was largely due to souring business investment, with gross fixed capital formation contracting 1.7% in 2012. Slowing exports were also a contributing factor, as it fell in real terms to 4.2% compared to 14.7% in 2010, as global growth was affected by the ongoing crisis in the euro zone and poor prospects in other advanced economies. Declining growth momentum in China was also a major contributing factor, as China takes in nearly a quarter of Korea's exports. Domestic consumption lent some support to the economy, as the government increased expenditures in the face of the slowing economy. Private consumption growth, however, slowed.

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



Source: IMF World Economic Outlook  
 Note: 2013-18 GDP are forecast figures

Chart 2: South Korean economic structure (2012)

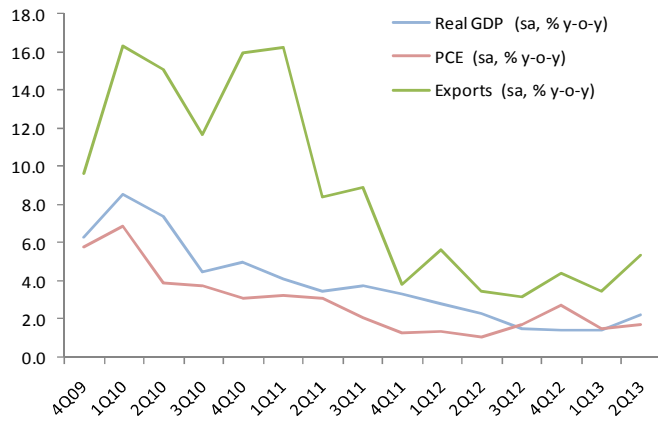


Source: CEIC, MARC Economic Research

On the supply side, the main drag on growth was a slowing expansion in manufacturing output, mirroring the slowdown in exports. The growth in manufacturing output moderated sharply from 14.7% in 2010 and 7.3% in 2011, to just 2.2% in 2012, while growth contribution of the manufacturing sector fell to about a third in 2012, from two-thirds in 2011. Growth drivers in 2012 were primarily in the services sector, particularly wholesale and retail trade, and from finance.

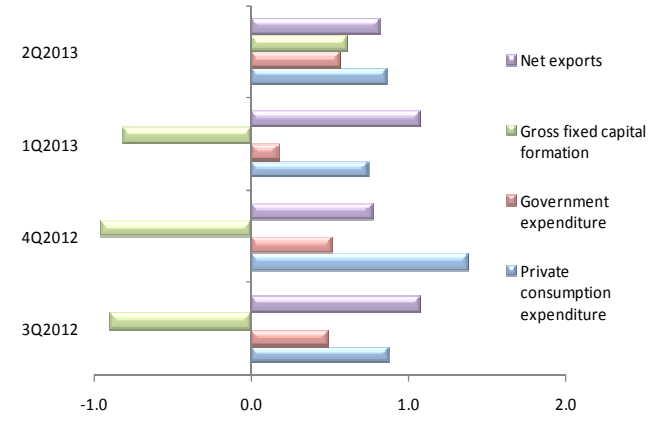


Chart 3: GDP growth (sa, % y-o-y)



Source: CEIC

Chart 4: Contribution to growth (sa, percentage points)



Source: CEIC, MARC Economic Research

### Latest Developments

The latest data suggests growth may be picking up again. Headline GDP expanded by 2.3% in 2Q2013, helped by accelerating growth in government spending and exports. More pertinently, investment expanded for the first time since 2Q2012, albeit at a fairly weak 2.5%. On the supply side, manufacturing growth remains weak at 2.0%, which questions the sustainability of the economic recovery, especially since growth in the services sector is poorer at an average of 2.1% for 1H2013 compared to an overall 2.5% growth in 2012. Nevertheless, a boost in construction output offers some grounds for optimism, as it signals stronger business confidence in the economy, which is somewhat confirmed by business surveys.

We expect growth prospects to remain challenging this year even as Europe's recession appears to be moderate and the US and Japan register stronger growths. The latest BoK forecast has GDP growth accelerating to 3.5% for 2H2013, bringing full year GDP growth to 2.8%, with the main drivers of growth being construction investment and higher trade activities. The forecast for 2014 on the other hand stands at 4.0%. These numbers remain below our estimate for Korea's trend growth at 4.3%. Given the weakness of growth in advanced economies and the slow deterioration in China's growth momentum, we think that the risks to the forecast are pretty high, and may be subject to considerable revision as circumstances dictate.

Table 1: GDP growth (sa, % y-o-y)

Growth (sa, % y-o-y)	3Q11	4Q11	1Q12	2Q12	3Q12	4Q12	1Q13	2Q13
<b>Gross Domestic Product</b>	3.7	3.4	2.9	2.3	1.5	1.4	1.5	2.3
<b>By Expenditure</b>								
Final consumption expenditure	2.3	1.4	2.1	1.6	2.1	2.9	1.4	2.2
(Private)	2.1	1.2	1.3	1	1.7	2.7	1.5	1.7
(Government)	3.2	1.8	4.9	3.6	3.4	3.6	1.3	3.8
Gross fixed capital formation	-1.2	-1.8	3.5	-2.9	-3.6	-3.8	-3.2	2.5
Exports of goods and services	8.9	3.8	5.6	3.5	3.2	4.4	3.5	5.3
Imports of goods and services	5.7	0.9	4.6	0.5	1.4	3.6	1.7	4.6
<b>By industry</b>								
Agriculture, forestry and fishing	-4.5	6.5	0.8	-1.9	0.4	-1.6	0.6	2.4
Manufacturing	6.4	5.5	4	2.6	0.9	1.3	1	2
Electricity, gas & water supply	1.3	5.1	1.6	1.6	2.1	6.1	1.8	-0.2
Construction	-2.4	0.3	2	-1.6	-2.3	-4.3	0.9	4.4
Services	2.7	2.3	2.5	2.8	2.5	2.3	1.9	2.2

Source: CEIC, BoK

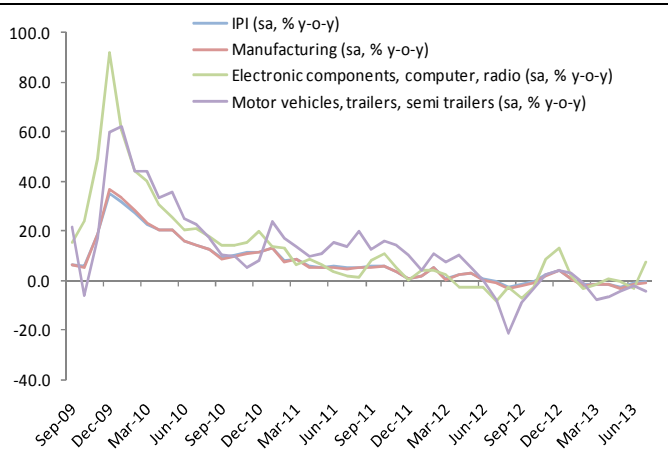
**Inflation is subdued**

In line with the rest of the region, Korea's inflation rate has moderated as commodity prices have come down from market highs and global economic activity moderated after the effect of post-crisis stimulus measures died away. Headline inflation peaked at 4.7% in August 2011, and has dropped since then to just 1.0% in May-June 2013. Core inflation has followed a similar pattern but lately been marginally higher than headline inflation, suggesting slightly stronger underlying domestic price pressures relative to imports. Nevertheless, by any measure, inflation is considerably subdued, allowing for monetary policy to respond to the growth slowdown seen over the past couple of years.

**Latest Developments**

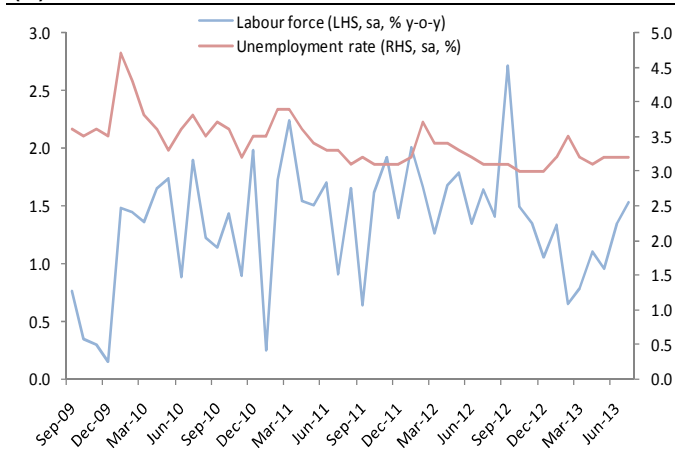
The latest data confirms subdued price pressures, although CPI inflation rose to 1.4% in July 2013 (Core inflation: 1.5%) compared to just 1.0% in June (Core: 1.4%). Much of the July increase in inflation comes from higher prices for food and transport, with contributions from agricultural products and recreation prices. Looking deeper however, prices in July were in aggregate not much higher than in January, as the Korean economy suffered price deflation in the period February-June 2013. Recent increases in global crude oil prices suggest that inflation may accelerate in the second half of the year, although we believe headline inflation should still come in below 2.0% by December.

**Chart 5: Industrial production (sa, % y-o-y)**



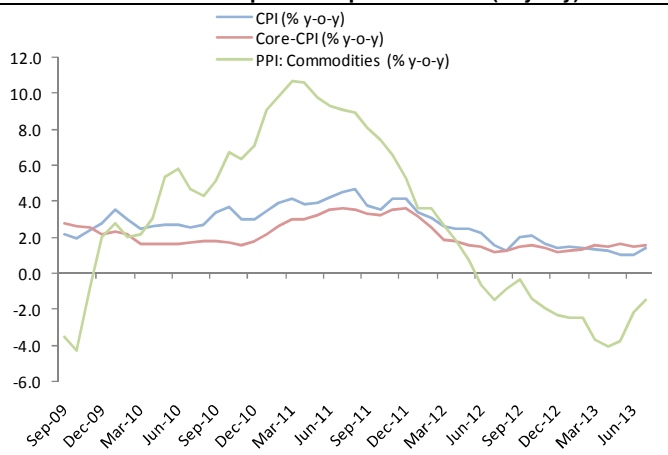
Source: CEIC

**Chart 6: Labour force growth (% y-o-y) and unemployment rate (%)**



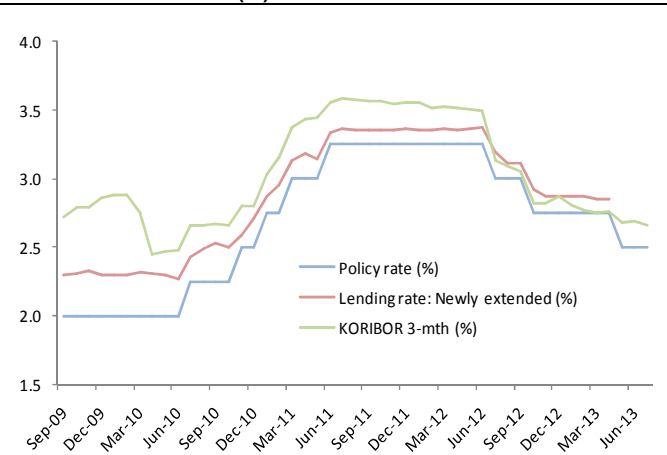
Source: CEIC

**Chart 7: Consumer and producer price indexes (% y-o-y)**



Source: CEIC

**Chart 8: Interest rates (%)**



Source: CEIC



### Monetary policy is accommodative

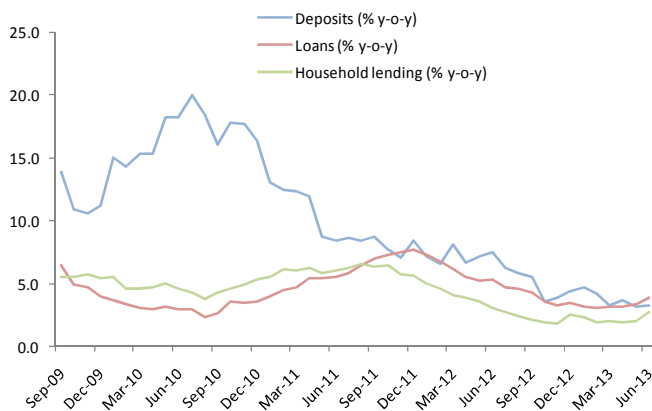
BoK began normalising interest rates in the aftermath of the Great Recession in 2H2010, raising the policy rate in 25bps steps from 2.00% in June 2010 to 3.25% by June 2011. This coincided with the peaking of headline inflation the month after and the build-up to the Greek crisis in the latter half of the year. Simultaneously, BoK substantially withdrew the liquidity support it provided to the domestic banking system during the crisis. However, as growth started to fall off in 2011-2012, BoK responded by loosening policy as growth forecasts started to deteriorate and money supply growth stalled. M1 growth hit bottom in 1Q2012, barely breaking 0.0% in February.

In line with the moderation in growth, total financing fell off from an average 7.0%-8.0% in 2010, to just above 5.0% in 2012. Household borrowing, a key risk factor for Korea's banking system, has also dropped in tandem, though lending through non-bank sources remains strong. Borrowing from credit cooperatives, for instance, is continuing to grow at double-digit rates. At more than a quarter of household borrowing, non-bank borrowing is a source of vulnerability for the financial system, as it is mostly uncollateralised. South Korea has already experienced overextended consumer borrowing which led 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.

### Latest Developments

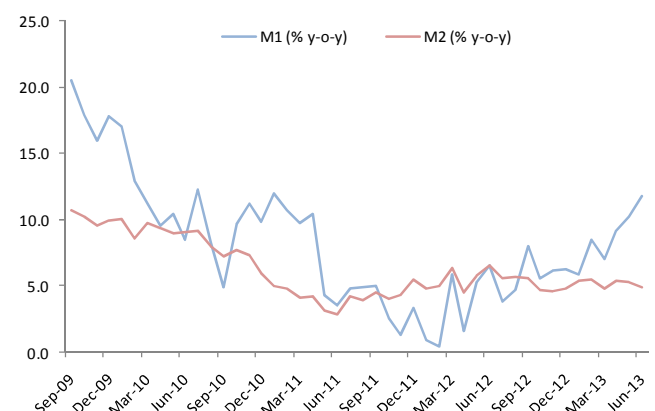
M1 growth has recovered dramatically since 1H2012, climbing to 11.8% in June 2013, although growth in the broader-based M2 aggregate, which better proxies economic activity, remains poor at 4.9% in June (June 2012: 6.5%). M2 components related to short-term commercial deposits are contracting and bank deposit growth in 1H2013 is nearly half the level of the year before at an average 3.7% versus 7.2% in 1H2012. Overall loan growth is similarly weak, with growth averaging 3.3% in 1H2013 compared to 6.1% in 1H2012. We foresee a pick-up in loan activity (and thus M2) going into the second half of the year, as BoK's rate cuts take hold and from an expected improvement in the business environment. After having brought the policy rate back down to within 50bps of its level at the Great Recession, we believe BoK will likely pause to take stock of the situation before committing to further monetary easing.

Chart 9: Total loans, deposits and household lending (% y-o-y)



Source: CEIC, MARC Economic Research

Chart 10: Money supply growth (% y-o-y)



Source: CEIC, MARC Economic Research

### Current account in surplus and reserves continue to accumulate

Despite a challenging external environment, South Korea has continued to record a healthy current account surplus, totaling USD43.1 billion in 2012 compared to USD26.1 billion in 2011 and USD29.4 billion in 2010. The capital and financial account on the other hand saw a larger deficit of USD43.6 billion (2011: -USD26.8 billion). International reserves have risen steadily, from a low of USD200.5 billion after the Lehman collapse, to USD327.0 billion at the end of 2012, reflecting the sustained trade surplus as well as the effort BoK has put in to manage hot capital inflows. Import cover however has declined, falling to an average 6.1 times from 6.6 times in 2010 and 7.9 times in 2009, as import growth has exceeded export growth from 2010 to 2012.

After the hammering in 2H2008, the KRW has stabilised and recovered its value against the USD and the euro (EUR). However, it remains substantially depressed against the Chinese renminbi (CNY) and Japanese yen (JPY). Hot money outflows remain a threat to the country's financial stability, especially in view of the banking system's reliance on short-term wholesale financing. We foresee that further reserve accumulation is 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.

### Latest Developments

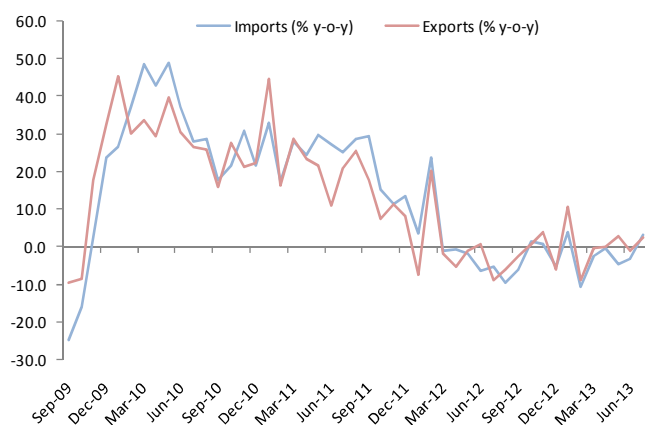
For 1H2013, the current account surplus has continued to expand strongly, more than doubling the total from the same period last year. The higher surplus was driven by a stronger trade surplus (1H2013: 126.1% y-o-y) counterbalanced by an equally strong inflow of capital. Fund inflows via the capital and financial account were 221.2% higher than in 1H2012, which were in turn 228.2% higher than in 1H2011. Inflows from both these sources have contributed to rising international reserves, although BoK has not appeared to be intervening heavily in forex markets, opting instead to bolster its gold holdings. After strengthening through most of 2H2012, the KRW has weakened against both the USD and against a broader slate of currencies, losing about 7% against the USD between December 2012 and June 2013, although a strong 3.2% recovery was posted in June. However, we do not see the KRW deviating too much from these levels against other regional currencies, although the USD outlook is clouded by prospects of monetary stimulus withdrawals by the US Federal Reserve.

Table 2: Balance of payments

USD million	2007	2008	2009	2010	2011	2012
Current Account	21,770	3,198	32,791	29,394	26,068	43,139
Goods	37,129	5,170	37,866	40,083	31,660	38,338
Services	-11,967	-5,734	-6,641	-8,626	-5,850	2,676
Primary Income	135	4,435	2,277	1,016	2,891	4,886
Secondary income	-3,527	-674	-712	-3,079	-2,633	-2,761
Capital and Financial Account	-23,877	-754	-34,651	-27,479	-26,778	-43,619
Capital Account	-2,388	109	290	-218	-25	602
Financial Account	-21,489	-863	-34,941	-27,261	-26,753	-44,221
Net Errors and Omissions	2,107	-2,444	1,861	-1,915	710	481

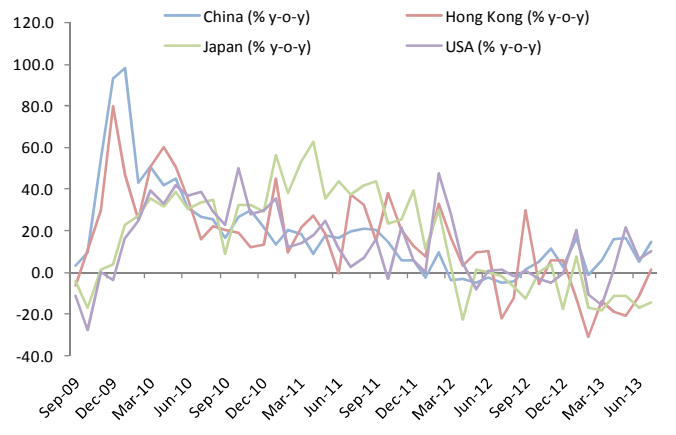
Source: CEIC

Chart 11: Exports and imports (% y-o-y)

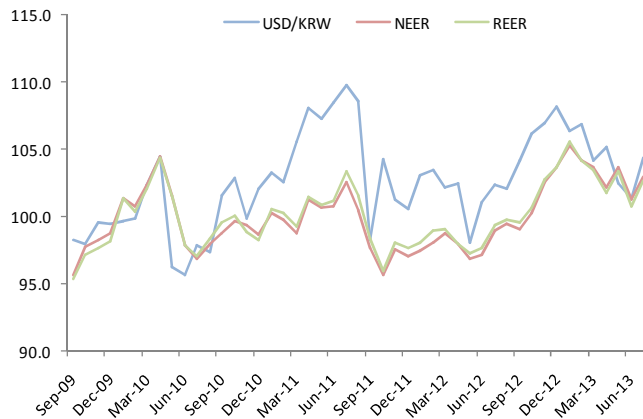


Source: CEIC

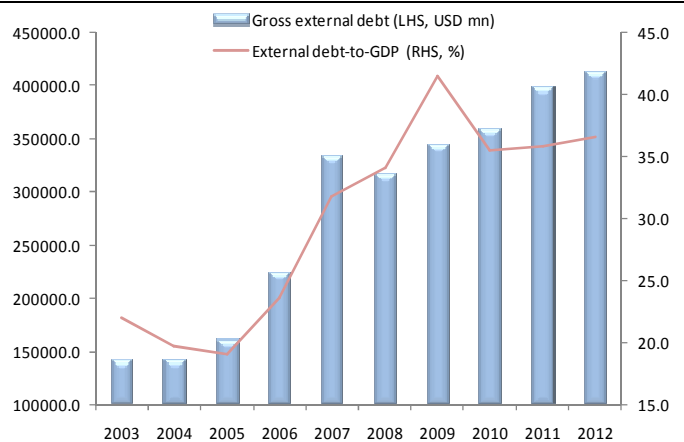
Chart 12: Exports to major trade partners (% y-o-y)



Source: CEIC

**Chart 13: USD exchange rate and effective exchange rate indexes (2010=100)**

Source: CEIC, MARC Economic Research

**Chart 14: Gross external debt (KRW bil) and ratio to GDP**

Source: CEIC, MARC Economic Research

### External debt situation improving

The external debt situation has stabilised in the aftermath of the Great Recession, with the resumption of growth and 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% y-o-y up to 3Q2008, but has since fallen to just 3.7% in 2012. Short-term debt rose even faster, before falling sharply in the recession and slowly declining afterwards. From a peak of 33.8% of GDP in 3Q2008 (and half of total external debt), short-term debt has fallen to 18.6% of GDP at the end of 2012 (30.7% of total external debt). Given the previously 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.

### Latest Developments

The external debt situation has continued to improve, with overall growth in external liabilities falling 0.3% in 1Q2013 from a year before. Short-term external debt has actually contracted, recording 9 contractions in the last ten quarters to 1Q2013. The debt profile has shifted to a less risky composition, with a greater portion from non-banks and for longer maturities. Banking system exposure has also improved, with the portion of long-term liabilities (which are less volatile) rising from 34.8% at end of 2008 to 53.3% at the end 2012.

### Government fiscal position is weakening but still solid

After registering a deficit in 2009, the central government has resumed the practice of keeping the government budget in surplus. The overall balance hit 1.5% of GDP in 2012 and 2011, from 1.4% of GDP in 2010, while debt outstanding has climbed marginally as a ratio to GDP, from 29.0% in 2008 to 33.4% in 2012. The debt ratio has increased, despite the budget surpluses recorded, due to slowing nominal GDP growth as Korea's external markets have either been in recession (Europe) or hit by declining growth (the US and China). The government's external debt is small at 12.9% of total government debt and just 4.3% of GDP. Revenue growth has averaged a steady 7.1% over the past decade, much faster than nominal GDP growth (5.9%), such that the government's effective tax yield from the economy has risen to an average of 23.8% of nominal GDP over the past five years (2008-2012) from 22.8% in the five years preceding that (2003-2007).

### Latest Developments

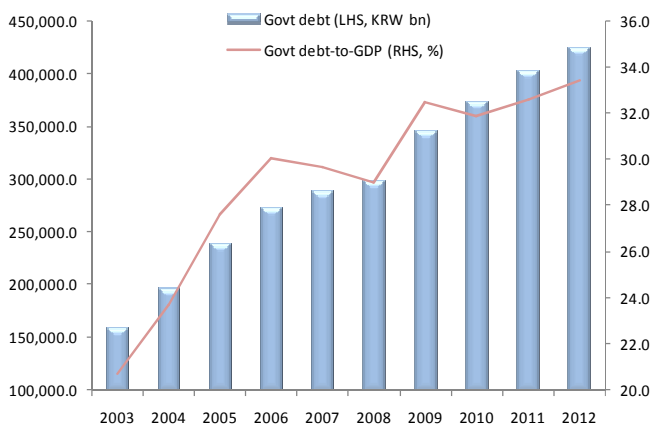
As growth has slowed going into 2012, the government's fiscal balance has also worsened. Up to 1Q2013, revenue is 11.1% below the level in the same period of 2012. The central government has responded by cutting expenditure but not to the same extent, with the result that the overall balance is in deficit to the tune of KRW14.8 trillion for 1Q2013 (or 1.2% of GDP). In addition, the government tabled a supplementary budget worth KRW17.3 trillion (or about 1.3% of GDP) in April 2013 to address job growth and still-weak investment, which is expected to boost growth by 0.3% and create 40,000 jobs. With both revenue shortfalls and additional fiscal stimulus, the government debt position is expected to worsen slightly to 36.2% of GDP.

**Table 3: Central government finances**

KRW billion	2007	2008	2009	2010	2011	2012
Total Revenue	243,633	250,713	250,810	270,923	292,312	311,456
Total expenditure and lending	206,584	234,854	268,431	254,231	273,694	292,977
Overall balance	37,049	15,831	-17,620	16,692	18,618	18,479
Overall balance (% GDP)	3.8	1.5	-1.7	1.4	1.5	1.5
Government debt (% GDP)	29.7	29.0	32.5	31.9	32.6	33.4

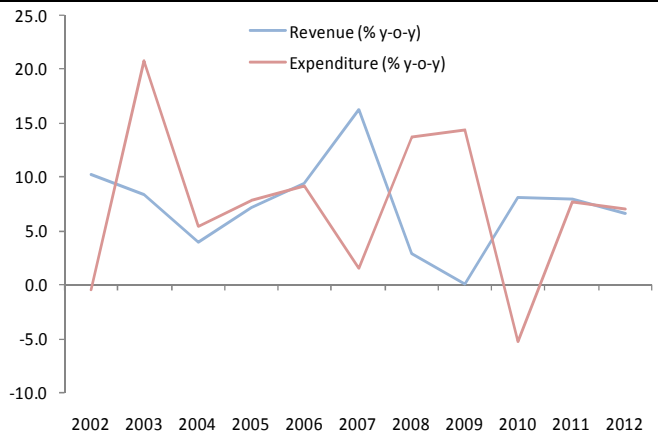
Source: CEIC

**Chart 15: Central government debt and debt-to-GDP ratio (%)**



Source: CEIC, MARC Economic Research

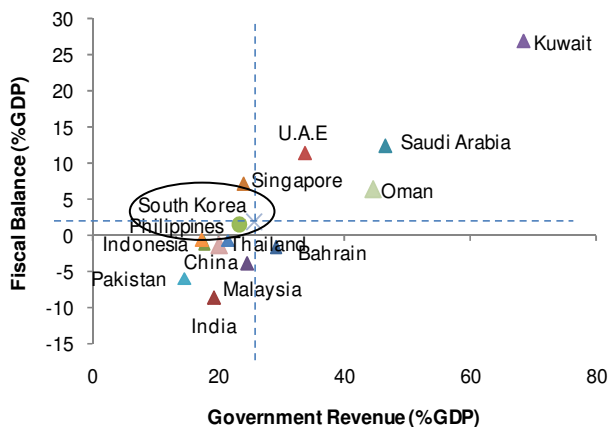
**Chart 16: Government revenue and expenditure growth (% y-o-y)**



Source: CEIC

**Comparison of five-year median macroeconomic matrices**

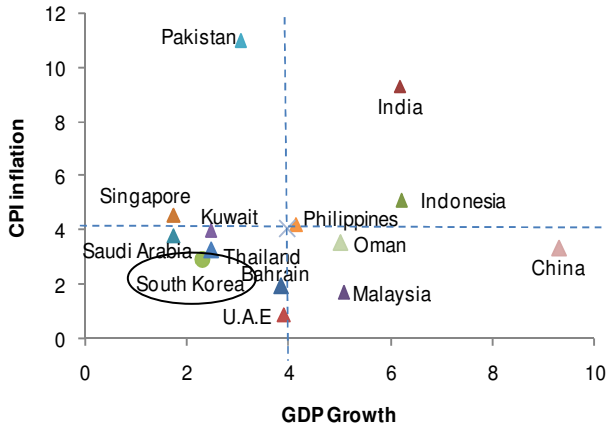
**Chart 17: Government revenue vs. Fiscal balance**



Sources: IMF & MARC Economic Research

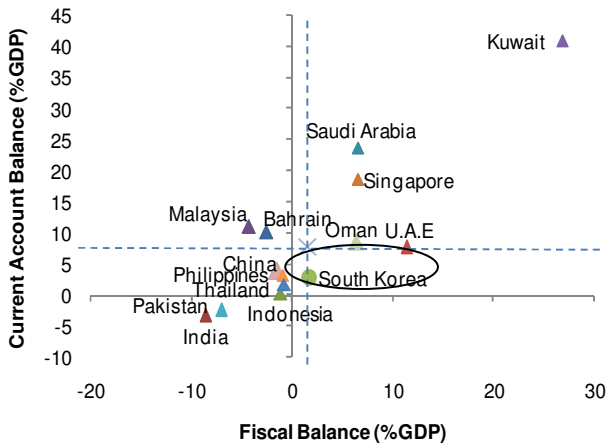
- In the revenue against fiscal balance matrix, South Korea resides in a relatively favourable quadrant, with a positive central government fiscal balance and revenue yield just below the average five-year median of the countries under our coverage.
- The government has considerable latitude for fiscal action in support of the economy, but has chosen to maintain a more moderate approach with a view towards maintaining medium-term fiscal sustainability.

Chart 18: CPI & GDP growth



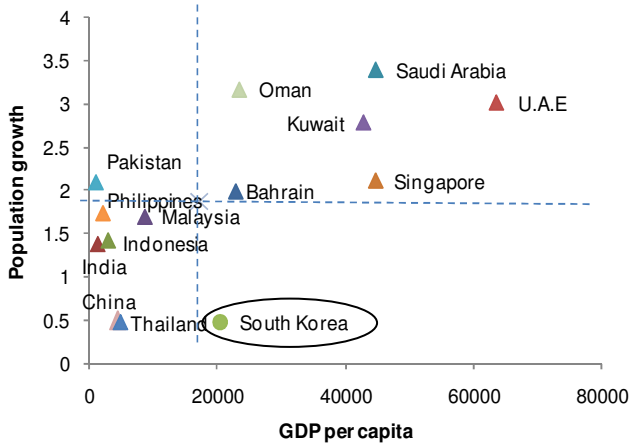
Sources: IMF & MARC Economic Research

Chart 19: Current account % of GDP vs. fiscal balance % of GDP



Sources: IMF & MARC Economic Research

Chart 20: Population growth vs. GDP per capita



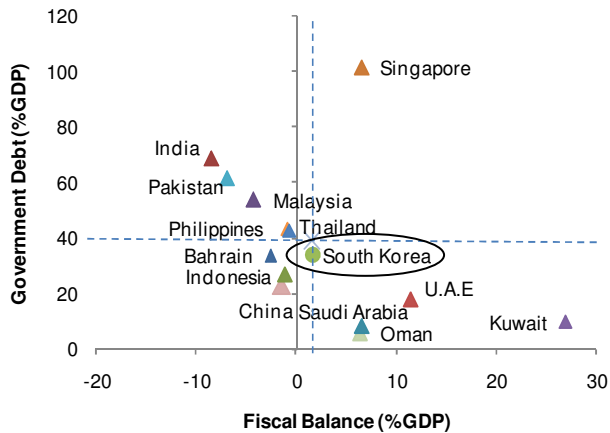
Sources: IMF & MARC Economic Research

- 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.
- South Korea's position in this matrix has deteriorated somewhat, as growth has been hampered by poor external demand. In addition, South Korea faces a future challenge to maintain growth in the face of a falling population growth rate and a rapidly ageing demographic.

- In the current account fiscal balance matrix, South Korea's current account surplus lies below the average of the sample, while its fiscal surplus puts it on the average.
- The sizes of the surpluses are small relative to the economy, which suggests little scope for boosting growth via increasing domestic absorption.

- South Korea's income per capita is on the high side, and considerably higher than in SE Asia. However, much like Japan, further gains in headline growth have become more difficult as population growth has slowed to just above replacement level.
- Also like Japan, but in contrast with the rest of the region, South Korea is a fairly equitable society, with income distribution far more evenly distributed within the population. South Korea's Gini index of around 32 compares well with Japan's 25, and much lower than Singapore's, Hong Kong's and Malaysia's, all of which have Gini numbers over 40.

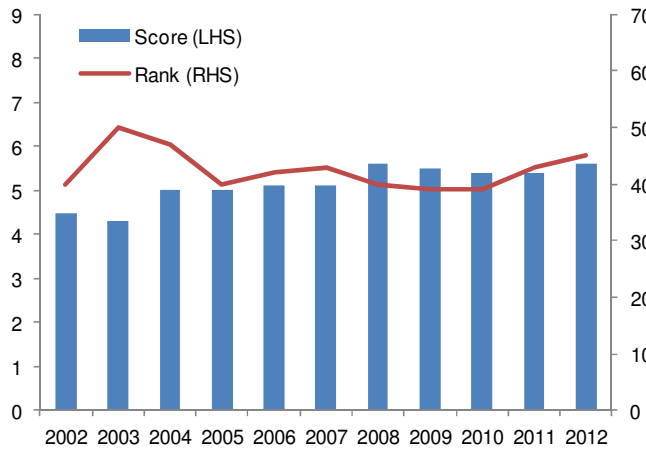
Chart 21: Govt. debt % of GDP vs. fiscal balance % of GDP



Sources: IMF & MARC Economic Research

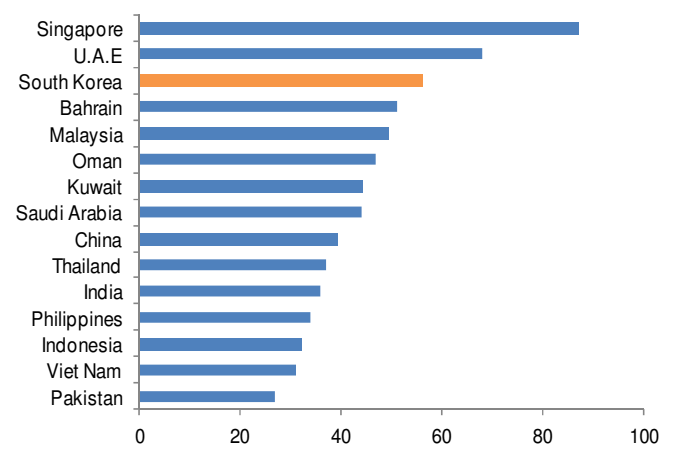
- In the debt to balance matrix, South Korea is nearly right on the average for our sample.
- With revenue growth continuing at a level on par with income growth and a fairly conservative approach to managing government finances, we expect this position to improve, even if the short-term position deteriorates.

Chart 22: Corruption perception index (South Korea)



Source: Transparency International

Chart 23: 2012 Corruption perception index (the higher the better)



Source: Transparency International

South Korea's corruption statistics remain relatively stable, though with slow and steady improvement in the index scores over the past decade. Based on the Corruption Perception Index by Transparency International, the overall perception score of corruption in South 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 2012 remains in the top quartile, at 45 out of 183 countries. These figures contribute to South Korea being among the highest rated in terms of corruption perception within our sample of countries.

Table 4: Summary of Macro Matrices

Matrix	Explanation
Government revenue and fiscal balance	South Korea is located in the second-best quadrant and is better than most of the countries covered, due to a budget surplus and revenue-to-GDP around the median level.
CPI and real GDP growth	South Korea is located in a relatively unfavourable position here, with slowing growth which is offset by low inflation.
Current account and fiscal balance	South Korea's current account surplus is below the average level of our sample, although still a positive risk indicator, while fiscal balance is around the average.
GDP per capita and population growth	Although South Korea has high GDP per capita, population growth is too low and can be a source of fiscal instability in the future.
Fiscal balance and government debt	South Korea's budget surplus and low government debt puts in right on the average for our sample.
Control of corruption	South Korea ranks favourably with an improving record of governance



## Appendix

## Vital statistics - Korea

	2007	2008	2009	2010	2011	2012	2013F
<b>National accounts</b>							
<b>Growth (%)</b>							
<b>GDP</b>	5.1%	2.3%	0.3%	6.3%	3.7%	2.0%	2.8%
<b>Supply side</b>							
Agriculture, forestry & fishing	4.0%	5.6%	3.2%	-4.4%	-2.1%	-0.6%	n.a.
Mining & quarrying	-4.1%	0.6%	-0.8%	-8.6%	-4.8%	1.3%	n.a.
Manufacturing	7.2%	2.9%	-1.5%	14.7%	7.3%	2.2%	n.a.
Electricity, gas & water	3.8%	6.2%	4.1%	4.3%	2.9%	2.8%	n.a.
Construction	2.6%	-2.5%	1.8%	-2.7%	-4.3%	-1.6%	n.a.
Services	5.1%	2.8%	1.1%	3.9%	2.6%	2.5%	n.a.
<b>Demand side</b>							
Total final consumption expenditure	5.1%	2.0%	1.2%	4.1%	2.3%	2.2%	n.a.
-Private final consumption expenditure	5.1%	1.3%	0.0%	4.4%	2.4%	1.7%	n.a.
-Government final consumption expenditure	5.4%	4.3%	5.6%	2.9%	2.1%	3.9%	n.a.
Gross fixed capital formation	4.2%	-1.9%	-1.0%	5.8%	-1.0%	-1.7%	n.a.
Exports	12.6%	6.6%	-1.2%	14.7%	9.1%	4.2%	n.a.
Imports	11.7%	4.4%	-8.0%	17.3%	6.1%	2.5%	n.a.
<b>Public finance (% of GDP) - Central government</b>							
<b>Total receipts</b>	25.0%	24.4%	23.5%	23.1%	23.7%	24.5%	23.5%
-Tax revenue	16.6%	16.3%	15.4%	15.1%	15.6%	16.0%	15.6%
-Non tax revenue	8.4%	8.1%	8.1%	7.9%	8.1%	8.5%	7.9%
<b>Total expenditure</b>	21.2%	22.9%	25.2%	21.7%	22.2%	23.0%	20.8%
<b>Fiscal balance</b>	3.8%	1.5%	-1.7%	1.4%	1.5%	1.5%	2.7%
<b>Government debt</b>	29.7%	29.0%	32.5%	31.9%	32.6%	33.4%	36.2%
<b>Inflation rate</b>							
Producer Price Index (PPI)	1.4%	8.5%	-0.1%	3.8%	6.7%	0.7%	n.a.
Consumer Price Index (CPI)	2.5%	4.7%	2.8%	2.9%	4.0%	2.2%	2.4%
<b>Money, banking and policy rates</b>							
M1 growth	-14.7%	4.5%	17.8%	9.9%	3.3%	6.3%	n.a.
M2 growth	10.8%	12.0%	9.9%	6.0%	5.5%	4.8%	n.a.
Bank credit growth (commercial and specialised banks)	14.9%	14.1%	4.0%	3.5%	7.7%	3.4%	n.a.
Loan-to-deposit ratio (commercial and specialised banks)	135.5%	135.8%	126.9%	113.0%	112.2%	111.1%	n.a.
NPL Ratio (commercial and specialised banks)	0.6%	0.9%	0.8%	1.1%	0.9%	1.0%	n.a.
Base Rate	5.00%	3.00%	2.00%	2.50%	3.25%	2.75%	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	2.1%	0.3%	3.9%	2.9%	2.3%	3.8%	1.7%
Capital & financial account	-2.3%	-0.1%	-4.2%	-2.7%	-2.4%	-3.9%	n.a.
Errors & omissions	-0.2%	0.3%	-0.2%	0.2%	-0.1%	0.0%	n.a.
International reserves (USD bn)	262.2	201.2	270.0	291.6	306.4	327.0	334.3
Reserve-to-import (in months)	6.9	4.5	7.9	6.6	5.8	6.1	n.a.
External debt - USD bn	333.4	317.4	345.7	359.8	398.7	413.6	440.3%
External debt - % of GDP	31.8%	34.1%	41.4%	35.4%	35.8%	36.6%	36.4%
Debt service ratio (% Exports of goods and services)	6.9%	7.9%	7.8%	6.8%	6.4%	7.4%	7.3%
<b>Development indicators</b>							
Population (in mn)	48.6	48.9	49.2	49.4	49.8	50.0	50.2
Population (growth)	0.5%	0.7%	0.5%	0.5%	0.7%	0.5%	0.4%
Human Development Index (HDI) - Very high human dev.	0.890	0.895	0.898	0.905	0.907	0.909	n.a.

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

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