Economic Research

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Country Risk Assessment: South Korea

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OVERALL RISK ASSESSMENT

South Korea is one of the world's most advanced industrial nations and located on the East Asian seaboard along the Korea Strait with the Sea of Japan and the Yellow Sea as its natural borders. Manufacturing has been the traditional driver of growth for the economy, although the services sector is taking an increasingly more important role. By contrast, the primary sectors have made little contribution to South Korea's growth or economic development. Ship-building was the initial foundation for economic development and continues to play a key role in industry, but South Korea's industrial conglomerates have since diversified into auto, consumer electronics and financial services.

South Korea has always practiced sound fiscal policies, with the budget balance in surplus in all but four of the last twenty years. Revenue collection has gradually increased to an average of 23.8% of GDP (2008-2012), while debt ratios are well below developed country norms. The Great Recession caused government debt to rise slightly from 29.0% of GDP in 2008 to about 33.4% of GDP by 2012, largely due to slowing growth in nominal GDP, but while still providing substantial fiscal space to the government. The government's external debt is also well in hand at 13.3% of total external debt and 4.8% of GDP. We expect to see some short term deterioration in the fiscal situation over the next couple of years due to prevailing economic conditions, but the Government of Korea (GoK) has considerable leeway in managing the situation.

Due to its high exposure to external demand, growth and economic activity in South Korea tends to ebb and flow with global trade volume. The Great Recession substantially impacted South Korean growth as global trade contracted. While recovery was swift, expansion since then has been sub-par, reaching just 2.0% in 2012 in contrast to around 5.0% growth before the Crisis. Poor investment growth compounded external weakness from troubles in the Euro-zone and the structural downshift in growth in China (Korea's largest trading partner).

Prospects for growth going forward remain challenging, due to Korea's ageing demographics and uncertain external demand conditions. The bulk of the working population is currently in the prime 40-50 age bracket, but the fertility rates are below replacement levels and the population is expected to begin declining by 2030-2035. As a result, headline growth should continue to drop from current levels, paralleling the Japanese experience. On the external front, South Korea's major markets of China and Europe are undergoing the same demographic transition, which would limit growth unless Korea manages to continue boosting productivity as well as expand exports into faster growing emerging markets. Over the immediate term, developed economies have yet to establish a solid foundation for recovery, while emerging economies such as those in South East Asia appear to be slowing as well. On the domestic front, rising investment and fiscal expansion should continue to support the economy in the interim, while South Korea's status as one of the world's most developed economies remains undisturbed.

Supporting this outlook are generally stable monetary conditions. Inflation has stabilised at around 0.7%-1.5% for 2013, allowing the Bank of Korea (BoK) to loosen monetary policy to sustain economic growth, cutting policy rates in 25 basis points (bps) steps from 3.25% to 2.5%. While the US dollar (USD) exchange rate has been somewhat volatile, the trade-weighted exchange rate has been much less so. Despite a challenging trade environment, South Korea also runs a substantial current account surplus, driven by a large positive balance on trade in goods. This is backed up by a substantial war chest of international reserves, ranked 8th largest in the world, as insurance against volatile capital flows.

Having undergone general elections recently, South Korea benefits from continuity in its political and regulatory regime, with the Saenuri Party continuing in power in both the legislative and executive branches of government. Governance metrics are generally good with a better than average ranking in the World Governance Indicators, while at seventh spot in the World Bank's Ease of Doing Business Report (2014). Corruption continues to remain a problem in South Korea, but corruption scores have generally improved over the past decade.

In some mitigation of the risk, while there has been considerable improvement in external debt, South Korea remains somewhat vulnerable to capital flow volatility. Although the level of external debt at around 36.0% of GDP is not high, the composition of that debt remains a concern. Despite falling from half of total external debt to 31.1% at the end of 2012, the ratio of short term to total external debt remains relatively high. Similarly, short term debt constitutes nearly half of banking system external liabilities, again despite considerable improvement over the past five years.

We are also cautious on the risk posed by financial instability. Overall metrics look good, with the banking system showing rising capital ratios and low non-performing loans (NPLs). However, the capital ratios should be buffered further, while growth in credit is mainly taking place outside the banking system. As Korea has a high level of household debt, and has already undergone a household debt crisis a decade earlier, we continue to evaluate this segment of the system as a potential source of vulnerability. While we have a greater comfort level with South Korea's banking risk than in the past, we think further improvement will solidify the risk outlook.

Table 1: Selected economic indicators –South Korea

	2007	2008	2009	2010	2011	2012
Real GDP Growth (%)	5.1	2.3	0.3	6.3	3.7	2.0
Real Exports Growth (%)	12.6	6.6	-1.2	14.7	9.1	4.2
Real Imports Growth (%)	11.7	4.4	-8.0	17.3	6.1	2.5
Current Account (% GDP)	2.1	0.3	3.9	2.9	2.3	3.8
Foreign Exchange Reserves (USD bn)	262.2	201.2	270.0	291.6	306.4	327.0
External Debt (% GDP)	31.8	34.1	41.4	35.4	35.8	36.2
Government Fiscal Balance (% GDP)	3.8	1.5	-1.7	1.4	1.5	1.5
Consumer Price Index (%)	2.5	4.7	2.8	2.9	4.0	2.2
Producer Price Index (%)	1.4	8.5	-0.1	3.8	6.7	0.7

Source: CEIC, MARC Economic Research

COUNTRY PROFILE

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 108th 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. South Korea is the seventh-largest trading partner of the United States and is also the 15th-largest economy in the world.

South Korea's population hit 50 million in 2012, making it the 26th 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 largely homogeneous, although English is widely taught in junior high and high school.

Figure 1: The map of South Korea

Source: CIA – The World Factbook

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. 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.

While Korea has been an enviable model of development success, 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.

ECONOMIC STRENGTH AND RISK

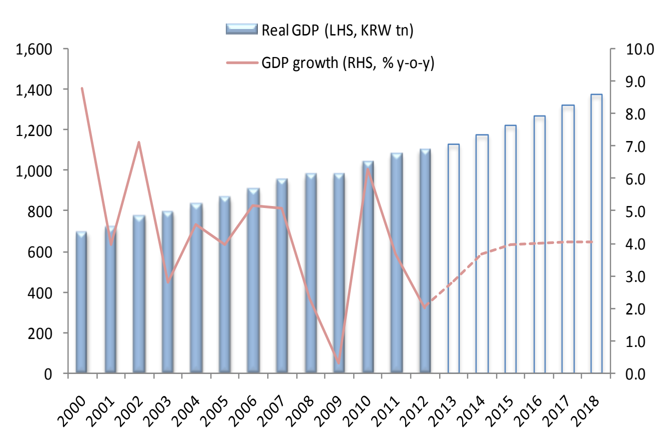
Main Drivers of the Economy

The economy's traditional strong point is the concentration on industry. However, as of 2012, services makes up the larger part of the economy with a 57.4% share of GDP, while manufacturing comprises 31.7%, a share that is still somewhat larger than the norm. 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.

Following the post-Crisis 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 on-going crisis in the Eurozone 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.

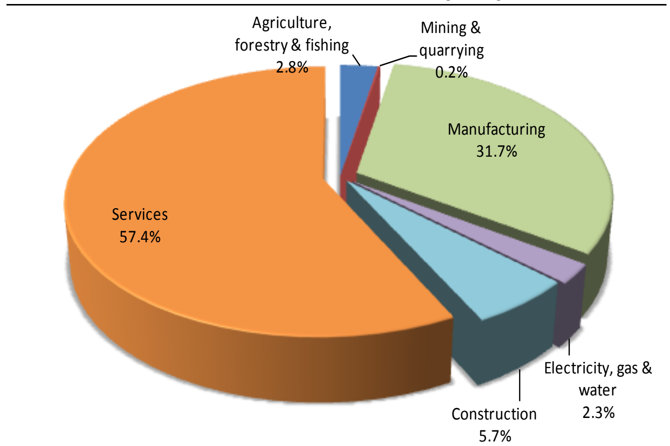
On the supply side, the main drag on growth was a slowing expansion in manufacturing output, mirroring the slowdown in exports. Manufacturing output moderated sharply from 14.7% in 2010 and 7.3% in 2011, to just 2.2% in 2012. The growth contribution of the manufacturing sector fell to about a third in 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 1: Real GDP and real GDP growth



Source: IMF WEO Database
Note: 2013-18 GDP figures are forecast figures

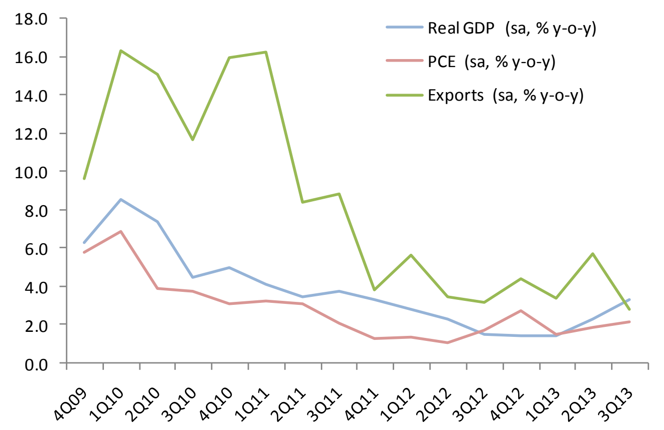
Chart 2: South Korean economic structure (2012)



Source: CEIC, MARC Economic Research

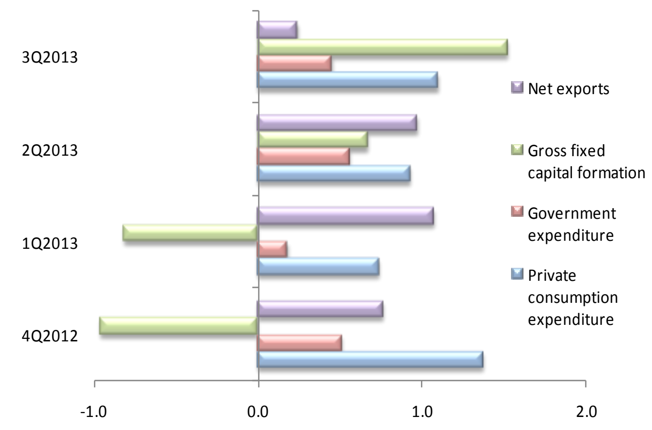
The latest data suggests growth may be picking up again. Headline GDP expanded by 2.3% in 2Q2013 and 3.3% in 3Q2013, helped by accelerating growth in government spending and exports. More pertinently, investment expanded for the first time since 2Q2012, accelerating to 2.7% in 2Q2013 and 6.3% in 3Q2013. On the supply side, manufacturing growth strengthened to 4.0% in 3Q2013, while growth in the services sector rose to 2.7%. The bounce in construction output (3Q2013: 4.6%) offers further grounds for optimism, as it signals stronger business confidence in the economy, which is somewhat confirmed by business surveys.

Chart 3: Real GDP growth (seasonal adjusted, % y-o-y)



Source: CEIC, MARC Economic Research

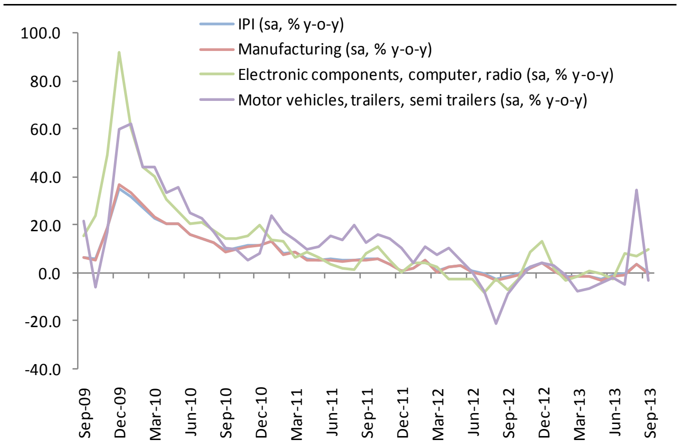
Chart 4: Contribution to growth (sa, % point)



Source: CEIC, MARC Economic Research

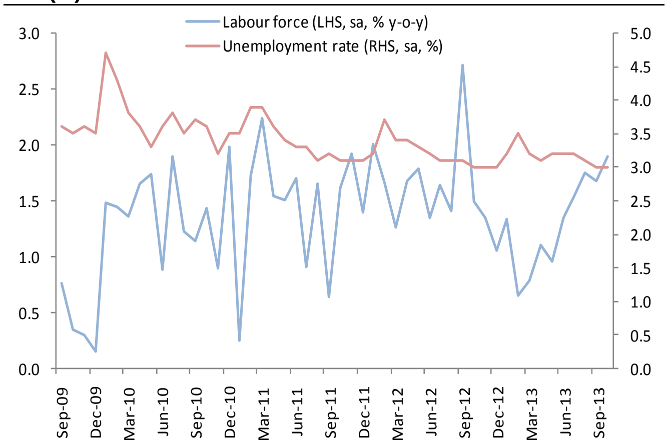
We expect growth prospects to remain challenging this year even as Europe's recession appears to be over and with stronger growth in the US and Japan. The latest BoK forecast has GDP growth accelerating to 3.5% for 2H2013, bringing full year GDP growth to 2.8%, with the main drivers of growth being construction investment and higher trade activities. The forecast for 2014 on the other hand stands at 3.8%. These numbers remain below our estimate for South 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 remain cautious on the risks to the forecast and will not be surprised if they are subject to revisions in the near term.

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



Source: CEIC, MARC Economic Research

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



Source: CEIC, MARC Economic Research

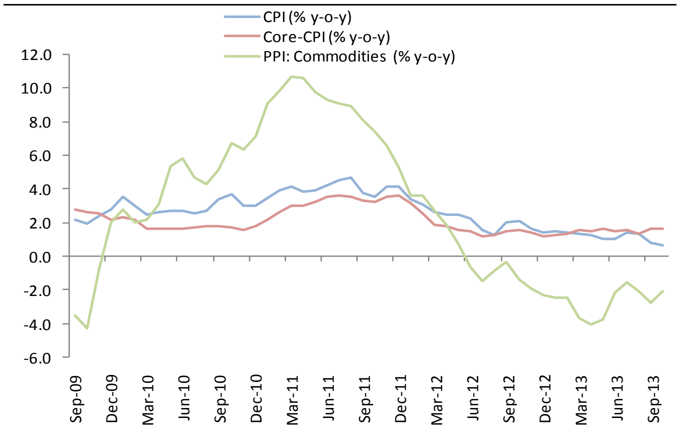
MONETARY AND EXCHANGE RATE MANAGEMENT

Inflationary Trends

In line with the rest of the region, South Korea's inflation rate has moderated as commodity prices have come off 2011 market highs and as 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 since dropped to just 1.0% in May-June 2013. Core inflation has followed a similar pattern but has 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 greater policy space for monetary policy to respond to the growth slowdown seen over the past couple of years.

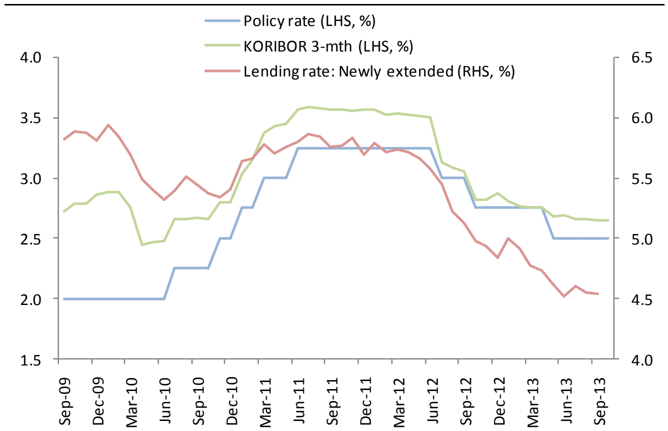
The latest data confirms subdued price pressures, with CPI inflation climbed by merely 0.7% in October 2013 (Core inflation: 1.6%) compared with 0.8% in September (Core: 1.6%). Much of the October slowdown in inflation comes from cheaper prices for agricultural and food products as well as transport prices. Looking deeper however, prices in October were in aggregate not much higher than in May, as the Korean economy suffered price deflation in the period February-June 2013. Recent increases in global crude oil prices suggests that inflation may accelerate in the final quarter of the year, although we believe headline inflation should still come in below 2.0% by December.

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



Source: CEIC, MARC Economic Research

Chart 8: Interest rates (%)



Source: CEIC

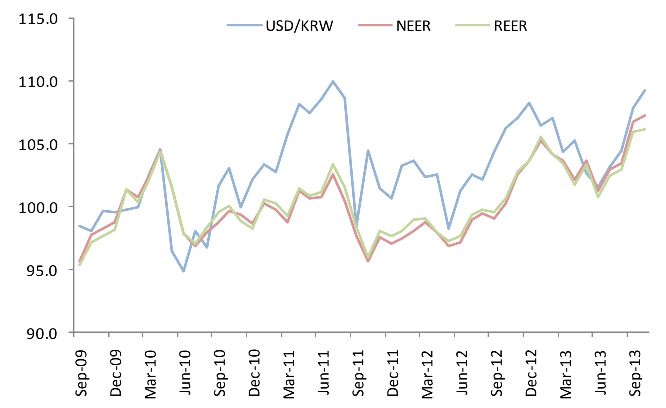
Monetary Policy

The BoK began normalising interest rates in the aftermath of the Great Recession in the 2H2010, raising the policy rate in 25bp steps from 2.0% 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, the 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, the 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% in February.

M1 growth has recovered dramatically since the 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.

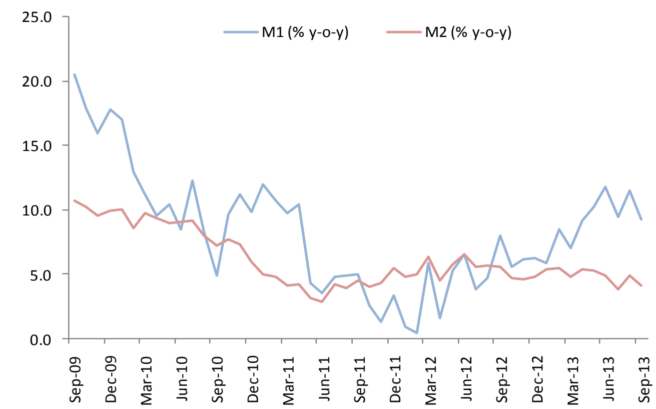
We foresee a pick-up in loan activity (and thus M2) going into the second half of the year, as the BoK's rate cuts take hold and from an expected improvement in the business environment. After having brought the policy rate back down to within 50bp of its level at the Great Recession, we believe the BoK will likely pause to take stock of the situation before committing to further monetary easing.

Chart 9: Exchange rate and effective exchange rate (higher indicates appreciation)



Source: CEIC, MARC Economic Research

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



Source: CEIC, MARC Economic Research

Exchange Rate

The Korean won (KRW) is designated an independently floating currency, within an inflation targeting monetary policy framework. Under this regime, the KRW is essentially in a free float system with BoK managing monetary policy based on the expected path of inflation.

After the hammering taken in the 2H2008, the KRW has stabilised and recovered its value against the USD and the euro (EUR). However, it remains substantially depressed against the Chinese yuan (CNY) and Japanese yen (JPY). Inflows from both these sources have contributed to rising international reserves, although the BoK has not appeared to be intervening heavily in foreign exchange 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 6.8% against the USD between December 2012 and June 2013, although a strong 8.3% recovery was posted between June and October.

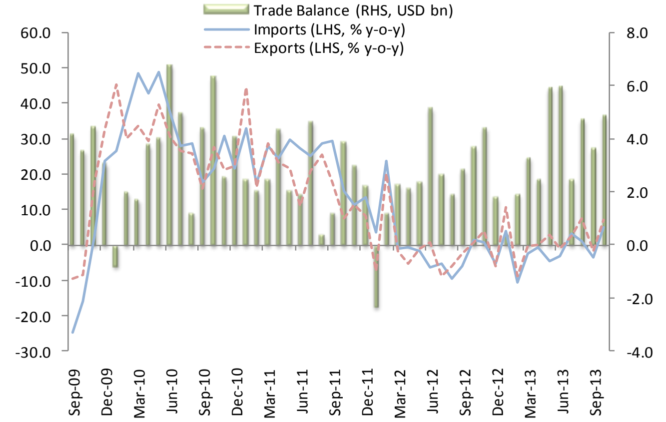
Foreign Trade

Despite a challenging external environment, South Korea has continued to record a healthy current account surplus, totalling 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 the BOK has put in to sterilise hot capital inflows. Import cover has declined however, 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.

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: 126.2% y-o-y) counterbalanced by an equally strong outflow of capital. Fund outflows via the capital and financial account were 221.2% higher than in 1H2012, which were in turn 228.2% higher than in 1H2011.

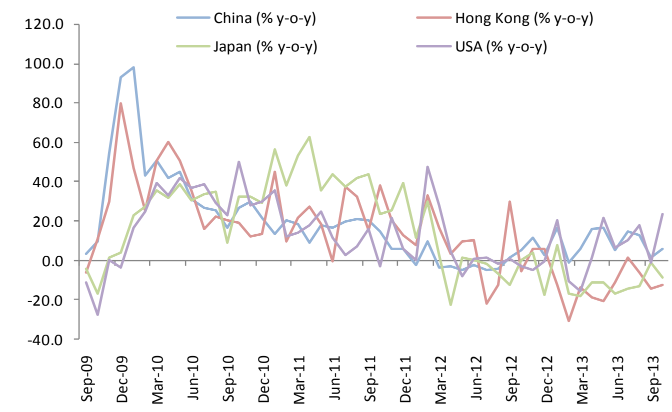
Going forward, prospects in foreign trade remain uncertain even though October trade numbers showed positive growth. While the news flow from both Europe and China have been more positive recently, recovery in Europe remains weak and volatile, while China is undergoing a secular decline in headline growth from declining investment growth, an overhang of excessive credit creation in the aftermath of the Great Recession, and a declining labour force. While South Korea's productivity growth has been impressive, this needs to be sustained while a more concerted effort is required to build new markets in faster growing emerging economies.

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



Source: CEIC, MARC Economic Research

Chart 12: Growth in exports to major trade partners (% y-o-y)



Source: CEIC, MARC Economic Research

Table 2: Balance of payments

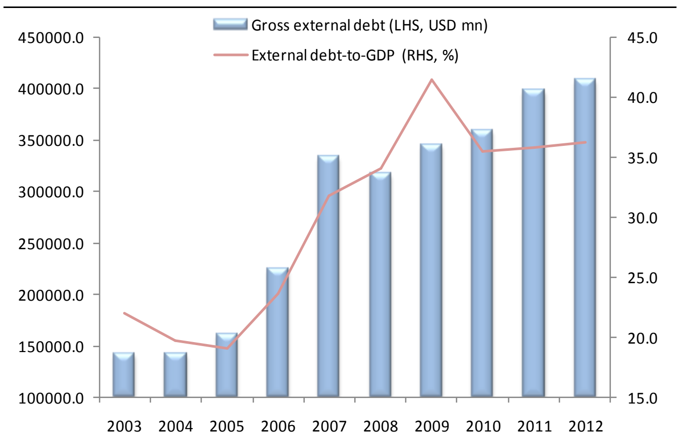
USD million	2007	2008	2009	2010	2011	2012
Current Account	21,770	3,198	32,791	29,394	26,068	43,139
- Goods	37,129	5,170	37,866	40,083	31,660	38,338
- Services	-11,967	-5,734	-6,641	-8,626	-5,850	2,676
- Primary Income	135	4,435	2,277	1,016	2,891	4,886
- Secondary income	-3,527	-674	-712	-3,079	-2,633	-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, MARC Economic Research

DEBT MANAGEMENT

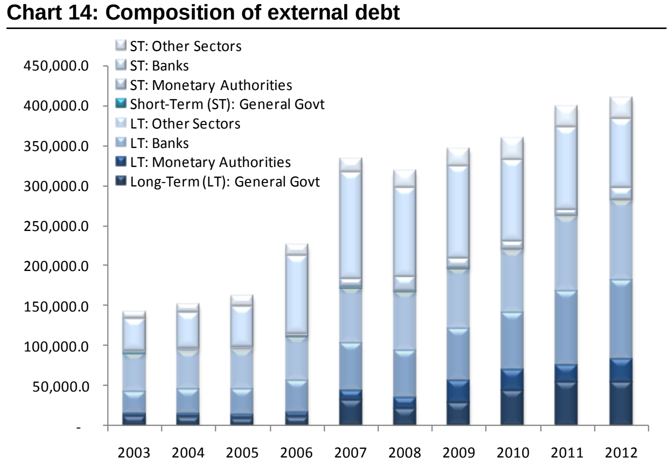
The external debt situation has stabilised in the aftermath of the Great Recession, with the resumption of growth and the recovery in the KRW's value. Prior to 2008, gross external debt was on an unsustainable growth trajectory, rising 48.1% in 2007 alone, and a further 23.4% y-o-y up to the 3Q2008, but has since fallen to just 2.7% 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 (31.1% of total external debt).

Chart 13: Gross external debt and ratio-to-GDP



Source: CEIC, MARC Economic Research

Chart 14: Composition of external debt



Source: CEIC, MARC Economic Research

The external debt situation has continued to improve over the past year, with overall growth in external liabilities falling 1.3% in 3Q2013 from a year before. Short term external debt has actually contracted, recording nine growth contractions in the last ten quarters to 3Q2013. 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.

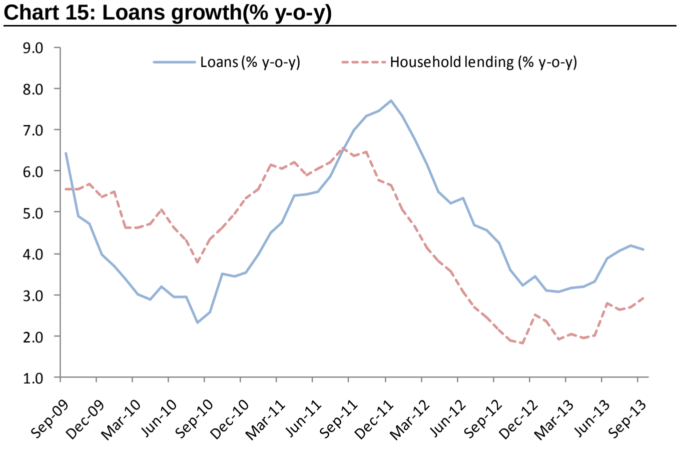
Given the previously heavy reliance of banks on short term external funding, the paying down of short term external debt reduces one critical source of vulnerability to macro-stability and moderates the consequences of sudden capital outflows. Hot money outflows however continue to remain a threat to 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. At the same time, we do not see the KRW deviating too much from current levels against other regional currencies.

We believe that there may also be some short term deterioration in the banking system's net foreign asset position, as global portfolio rebalancing moves funds back into advanced economy markets. However, the improvement in the external debt composition, both in terms of a reduced financial sector presence and in the maturity profile, are likely to be sustained over the medium term. To balance this, the country's short term external debt ratio is still relatively high, and warrants close monitoring.

BANKING SYSTEM STABILITY

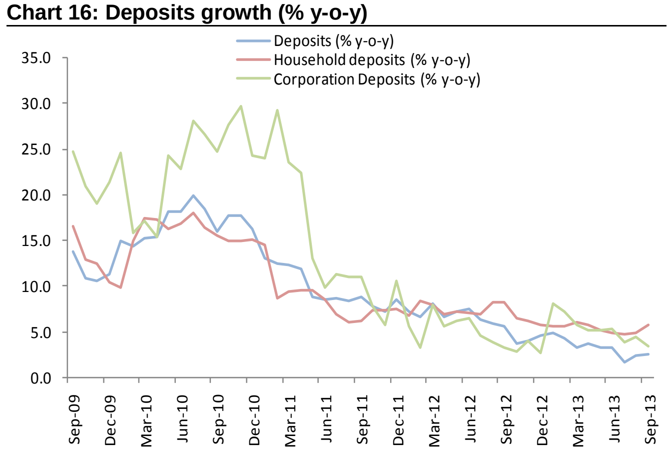
South Korea's banking system is dominated by seven national banks, including KB Kookmin Bank (the largest in terms of assets), Korea Exchange Bank, Shinhan Bank, Woori Bank, Hana Bank, and Citibank Korea and Standard Chartered Korea. In addition, state owned banks are also large and active (also known as specialised banks), such as Korea Development Bank and Korea Eximbank. Apart from the national banks, South Korea also has six local banks, 39 foreign banks, 91 mutual savings banks, and nearly 3,000 credit cooperatives. Another 67 are specialised finance companies offering credit card, leasing and venture capital services.

Chart 15: Loans growth(% y-o-y)



Source: CEIC, MARC Economic Research

Chart 16: Deposits growth (% y-o-y)

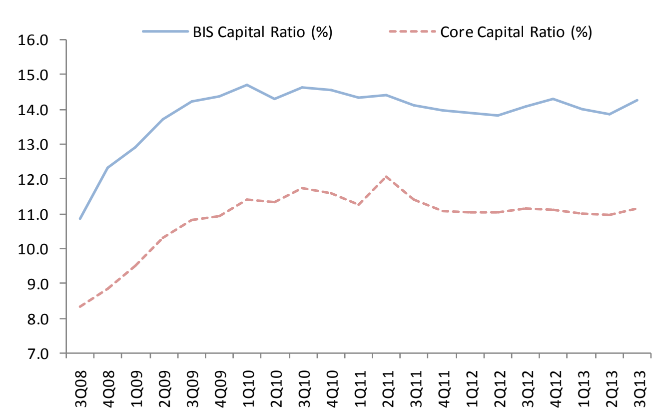


Source: CEIC, MARC Economic Research

Capital ratios for South Korea's domestic banks have improved, and both overall and core capital ratios were progressively strengthened in the aftermath of the Great Recession. From 10.9% and 8.3% in the 3Q2008, capital and core capital ratios have risen to 14.3% and 11.1% in the 3Q2013. However, we think this should be improved further, as the capital buffers will be inadequate in the event of another crisis. Asset quality is fairly good, with NPL ratios fairly stable at between 0.8% and 1.3% over the past five years. Overdue loans have risen since the Great Recession, peaking at 2.3% in the 3Q2010, but falling back to 1.7% in 2Q2013.

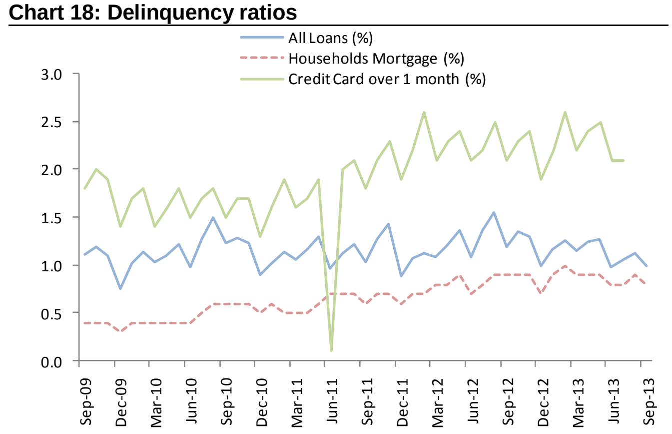
In line with the moderation in economic growth, total financing fell off from an average 7%-8% in 2009, to just above 5% in 2012. Household borrowing, a key risk factor for South Korea's banking system for the past decade, has also dropped in tandem though lending through non-bank sources remains strong. 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 thus 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 and slowing household credit growth.

Chart 17: Capital ratios



Source: CEIC, MARC Economic Research

Chart 18: Delinquency ratios



Source: CEIC, MARC Economic Research

Loan growth over the first half of 2013 has continued the downtrend seen in 2012, while M2 growth remains poor. However, there are signs that credit growth is starting to pick up again, particularly to the corporate sector. Banking system loan growth hit 3.9% in June after hitting a nadir of 3.1% in February. Most of the growth is coming from outside commercial banks, via specialised banks and non-bank financial corporations. Foreign exchange liquidity risk has been substantially muted, as the banking system's net foreign asset position is now strongly positive.

We think loan growth will improve but stay muted over the short term, as monetary policy easing begins to take hold. We expect loan growth to pick up more strongly after the year-end, as lower borrowing costs are transmitted into the economy. Banking system liquidity risk has fallen sharply in the last five years, from an improvement in the external exposure as well as strong deposit growth. Risks from over-extended households are also less marked, as household credit growth has lagged overall loan growth since 2012. Given these developments, we thus have a greater comfort level with South Korea's banking system risk than in the past, though it remains a weak point in the overall risk assessment.

Table 3: Banking statistics

Banking sector indicators	2007	2008	2009	2010	2011	2012
BIS Capital Ratio (%)	12.3	12.3	14.4	14.6	14.0	14.3
Core Capital Ratio (%)	9.0	8.8	10.9	11.6	11.1	11.1
NPL Ratio (%)	0.6	0.9	0.8	1.1	0.9	1.0
Loans-to-Deposits Ratio (%)	135.5	135.8	126.9	113.0	112.2	111.1

Source: CEIC, MARC Economic Research

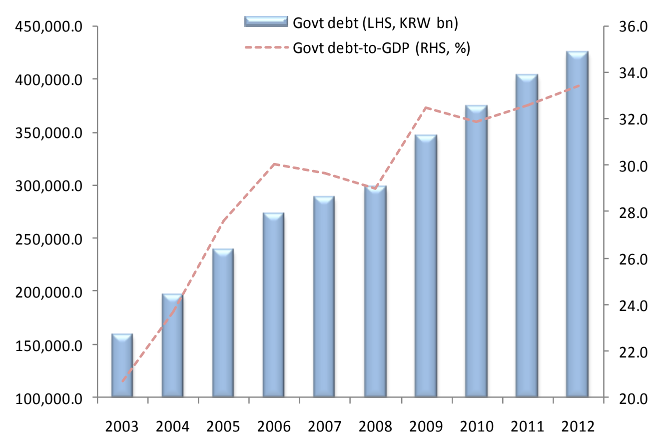
FISCAL STABILITY

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 South Korea's external markets have either been in recession (Europe) or hit by declining growth (US and China).

The government's external debt is small at 13.3% of total external debt and just 4.8% 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).

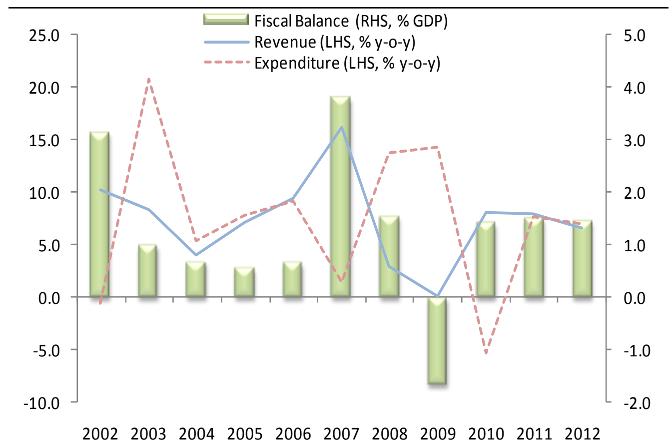
As growth has slowed going into 2012, the government's fiscal balance has also worsened. Up to 3Q2013, revenue is 0.6% below the level in the same period of 2012. The central government has responded by cutting expenditure but not to the same extent, with the result that the overall balance is in deficit to the tune of KRW2.1 trillion for 3Q2013 (or 0.2% 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 35.7% of GDP.

Chart 19: Central government debt and debt-to-GDP ratio



Source: CEIC, MARC Economic Research

Chart 20:Government finance



Source: CEIC, MARC Economic Research

We judge government finances to be in good shape, with sustainable debt ratios, solid revenue growth and a relatively balanced budget. While anemic growth and the need to support the economy over the short term are likely to worsen the government's fiscal position, past historical prudence has provided the GoK substantial fiscal space to approach the economy's problems with flexibility.

Table 4: Government finance

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

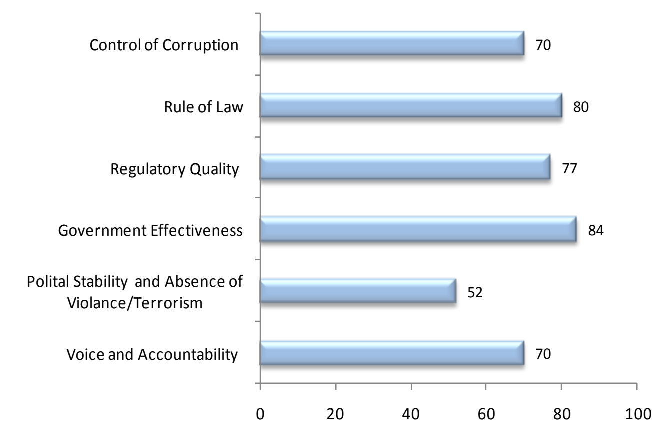
Source: CEIC, MARC Economic Research

POLITICAL AND INSTITUTIONAL RISKS

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 300 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.

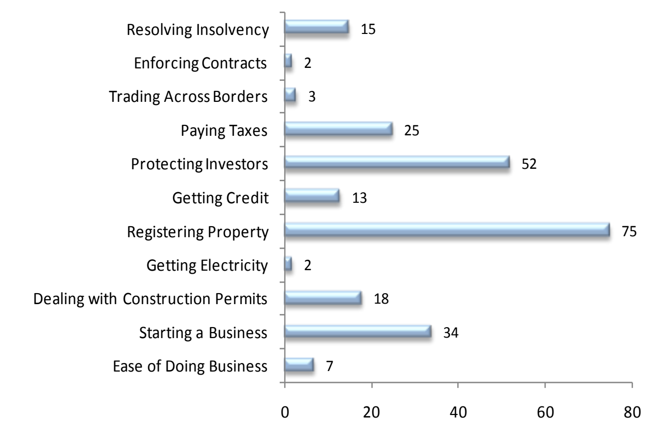
The country has nine provinces and seven administratively distinct cities: the capital of Seoul, Busan, Daegu, Daejeon, Gwangju, Incheon and Ulsan. South Korea has a diverse political party landscape, but the legislature is currently dominated by the conservative Saenuri Party (formerly the Grand National Party or GNP) and the left-leaning Democratic United Party.

Chart 21: World Governance Indicators 2013 ranking (percentile ranking, higher is better)



Source: World Bank

Chart 22: World Bank Ease of Doing Business 2014 ranking (lower is better)

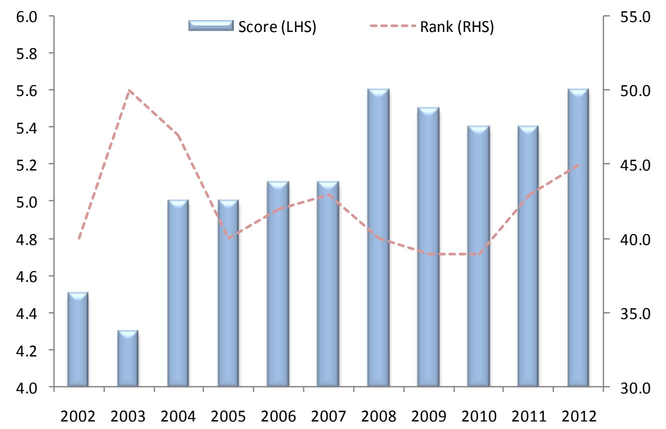


Source: World Bank

From 2007-2012, the President was Lee Myung-Bak of the GNP, who won 48.7% of the vote. A former Chairman and CEO of Hyundai Construction, he also served as mayor of Seoul from 2002-2006. Marred by scandals, substantial civic opposition to some of his policies and allegations of corruption within his administration, President Lee has proven a controversial figure and did not command the full support even of his own party. Lee's economic policy centred on privatisation and market-friendly measures, including the ratification of the Korea-US free trade agreement. His foreign policy was aggressive and extensive, raising Korea's profile in the global community, while shifting to a hardline stance with respect to North Korea.

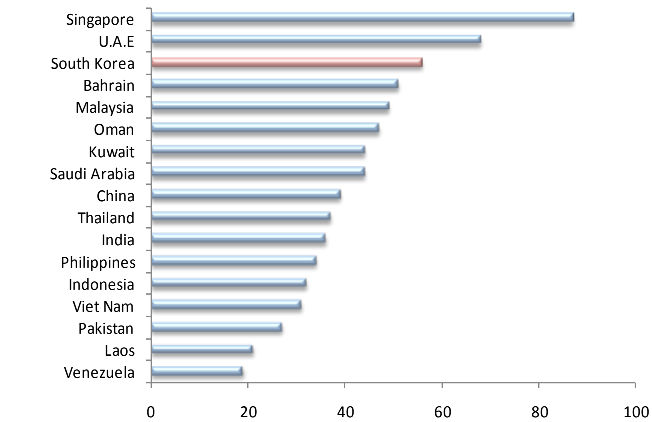
Despite the taint of potential corruption, President Lee's administration saw South Korea's Corruption Perception Index score improve from 5.1 in 2007 to 5.4 in 2011 (the 2012 score is not comparable with past scores). South Korea's scores under the World Governance Indicators were also either stable or showed some slight improvement, although its average rank is poor given its developed status, and generally in the second or the lower half of the first quartile of the rankings from a sample of 215 countries. South Korea scores well on government effectiveness, regulatory quality and rule of law (all of which were in the top quartile), but does sharply worse in terms of political stability (not much above average). In contrast, South Korea's ranking in the World Bank's Ease of Doing Business report is among the highest at seventh spot for 2014, largely due to contract enforcement (ranked 2nd), electricity supply (2nd), and cross-border trading (3rd). Korea is also among the top-30 in construction permits, getting credit, paying taxes and resolving insolvency. Where Korea could use improvement are in property registration (75th) and investor protection (52nd).

Chart 23: Corruption Perception Index rank and score



Source: Transparency International

Chart 24: Corruption Perception Index 2012 (the higher the better)



Source: Transparency International

The current President is Park Geun-hye from the Saenuri Party, the first woman President in Korean history and 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. President Park is a daughter of Park Chung-hee, who overthrew the elected government in 1961, and led the country for 18 years until his assassination in 1979.

Given that the elections have been comparatively recent, Korea has executive and legislative stability at least until the end of 2016 when new elections for the legislature are due, while the Presidential election is set for 2018. President Park with her more domestic-oriented focus has so far proven to be popular among voters, with an approval rating that has risen to 68% as of the latest reading. The executive administration was streamlined early in her administration, with a new Deputy Minister for Economic Affairs created.

Philosophically, the shift towards a more family and individual oriented approach signals a turn to the left, and President Park's administration may not be as market friendly as her predecessor proved to be. Nevertheless, we expect no major shift in regulatory or economic policy that would impinge on South Korea's credit risk, although it should be stressed that it is very early days in President Park's administration. Her past career indicates she is an able politician who is adept at mobilising popular support, which we take to be a positive sign that political stability and regulatory consistency is likely to be preserved over her term of office. If there is a negative, we believe it possible that the government will err on the side of social welfare and less on fiscal prudence over the next few years. Coupled with a secular slowdown in growth, that may worsen the government's fiscal position over the medium term.

ANNEXURE

Vital statistics - Korea

	2007	2008	2009	2010	2011	2012	2013F
National accounts							
Growth (%)							
GDP	**5.1%**	**2.3%**	**0.3%**	**6.3%**	**3.7%**	**2.0%**	**2.8%**
Supply side							
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.
Demand side							
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.
Public finance (% of GDP) - Central government							
Total receipts	**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%
Total expenditure	**21.2%**	**22.9%**	**25.2%**	**21.7%**	**22.2%**	**23.0%**	**20.8%**
Fiscal balance	**3.8%**	**1.5%**	**-1.7%**	**1.4%**	**1.5%**	**1.5%**	**2.4%**
Government debt	**29.7%**	**29.0%**	**32.5%**	**31.9%**	**32.6%**	**33.4%**	**35.7%**
Inflation rate							
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%	1.4%
Money, banking and policy rates							
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.
Balance of payments (% of GDP)							
Current account	2.1%	0.3%	3.9%	2.9%	2.3%	3.8%	4.6%
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	409.4	440.3
External debt - % of GDP	31.8%	34.1%	41.4%	35.4%	35.8%	36.2%	36.4%
Debt service ratio (% Exports of goods and services)	6.9%	7.9%	7.8%	6.8%	6.4%	7.4%	7.3%
Development indicators							
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.

Source: CEIC, BoK, IMF, UNDP, MARC Economic Research

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