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South Korea: Country Risk Insight

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In a nutshell

- South Korea’s overall economic strength undoubtedly lies in the foundation of its well-diversified economy, which is a reflection of credible and proactive economic policies. The significant expansion of its per capita gross domestic product (GDP) in purchasing power parity (PPP) terms to USD33,791 in 2013 from a low of USD2,300 in the early 1980s is an indication of its economic vibrancy and vitality. Overall economic performance remains broadly resilient (2014: 3.3%; 2013: 3.0%), notwithstanding the quarterly growth slowdown since 2Q2014 after the deadly Sewol ferry disaster.

- The Bank of Korea (BoK) has been credible and proactive in terms of monetary policy response. It has a good track record of dealing with past economic challenges such as escalating real estate prices prior to 2009 and the economic downturn during the Global Financial Crisis (GFC). It also has a good grip on inflation. The overall inflationary trend has remained subdued, holding at 1.3% in 2014 for the second consecutive year. This has offered some policy space for the central bank to respond to weakening domestic demand; in the eight months through March 2015, it lowered the policy rate by a cumulative 75 basis points (bps) to a record low of 1.75%, while official lending rates drifted below 4.0% in the six months through April 2015. As a result, overall lending has rebounded swiftly.

- Fiscal policies in South Korea have been generally sound, and the government has a proven track record of keeping the budget mostly in surplus. Although the overall balance is expected to slightly worsen in the short to medium term, the deterioration reflects the country’s current expansionary fiscal stance that is aimed at economic recovery and developing future growth engines. South Korea’s overall government debt metrics remain manageable; in 2014, debt as a percentage of GDP stood at a respectable 33.9% (2013: 32.5%), well below the norm in advanced countries (OECD average in 2013: 84.7% of GDP). More importantly, as the bulk of the borrowings were and continue to be from domestic sources, foreign currency risk is low.

- South Korea’s external finances have continued to improve in spite of a challenging external environment. In 2014, the current account (CA) surplus reached a 16-year high of 6.3% of GDP (2013: 6.2% of GDP). Going forward, it is expected to widen further in the short term largely on account of persistently low global crude oil prices. Also, for the very first time in 2014, South Korea registered a positive net international investment position (IIP), enhancing its position as a net creditor nation. Its external debt profile is also improving; short-term obligations, which make up just 27.1% of total external debt, are more than matched by short-term external assets, which are 4.5 times larger. Moreover, a high level of international reserves – at 3.2 times the size of short-term obligations and ranked seventh-largest in the world – should provide an adequate cushion in the event of massive capital outflows.

- Notwithstanding the positive attributes, MARC views with concern the accelerating growth of household leverage even though the pace has somewhat moderated. In 2014, household debt reached a record high of 138.0% of disposable income and 73.3% of GDP (2013: 134.2% and 71.5%, respectively). As South Korea has already had a history of overextended consumer borrowings, MARC views this segment as a potential source of financial vulnerability. However, risks have been tempered by the high level of household financial assets relative to household financial liabilities (2.0 times). Also, recent Financial Services Commission (FSC) data show that the household debt structure has continued to improve; specifically, 70% of borrowers are from high income households who can afford debt repayment.

- Persistent geopolitical concerns arising from its proximity to North Korea is another downside risk. Although the Korean War ended in 1953, the Korean Peninsula remains technically in a state of war as a formal peace treaty has yet to be signed. While the North Korean leader had hinted early in the year of the possibility of high-level talks with South Korea, the prospect of that happening remains in question. MARC is of the view that unification of the two Koreas remains unrealistic at the current juncture, though there could be some short-term gains for both sides should there be talks, particularly on issues of economic exchange, security and nuclear weapons.

Key Strengths

Well-diversified, high-income economy

Highly competitive and innovation-driven, South Korea is ranked number 26 out of 144 in the World Economic Forum's (WEF) Global Competitiveness Index (GCI) 2014-2015. The significant expansion of its per capita GDP (PPP) to USD33,791 in 2013, up from a low of USD2,300 in the early 1980s, is an indication of its economic vibrancy and vitality. South Korea is a member of the Organisation for Economic Co-operation and Development (OECD). It is the 30th wealthiest nation in the world, and is comparable to Japan (USD36,653) and the United Kingdom (USD36,207).

South Korea's well-diversified economy, one of its key strengths, reflects credible and proactive economic policies. Despite recent weaknesses since 2H2014, the economy remains relatively resilient, thanks to its diversity. In 2014, the manufacturing sector accounted for 29.0% of GDP, somewhat larger than the norm for advanced countries, while the service sector's share was 53.5%.

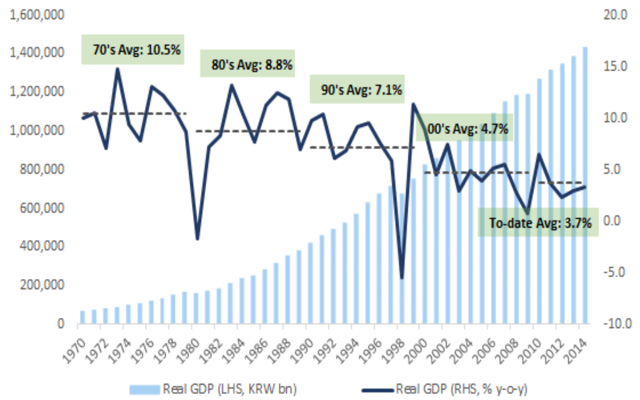
South Korea's long-term growth trend stands at approximately 5.3%. However, post-GFC, its average economic growth pace in the five years through 2014 has moderated to just 3.7% per annum. Notwithstanding the slowdown, seen as a sign of fading growth potential, the South Korean economy has continued to perform reasonably well, especially when compared to its OECD peers (post-GFC average: 1.9%), though its growth volatility was relatively higher at 1.6% (OECD: 0.7%).

The post-GFC pullback in growth was largely due to souring domestic demand. For example, in 2014, growth in private consumption declined to a five-year low of 1.8%; it added just 0.9 percentage points to overall headline growth, the least since 2009. Subpar business investment was also a contributing factor; in 2014, growth in total investment dropped to 3.1% from 3.3% in the preceding year.

Being an open economy, lingering uncertainties in the euro zone as well as the poor economic performance of other major economies – save for the United States (US) – have taken a toll on South Korean export performance. Real export growth moderated for a third consecutive year in 2014 to 2.8% (2013: 4.3%), down from its cyclical high of 15.1% in 2011. Notwithstanding this, South Korea's overall economic performance in 2014 was the best yet since 2011; real GDP growth surprisingly accelerated to 3.3% (2013: 3.0%), due mainly to lower reductions in inventories.

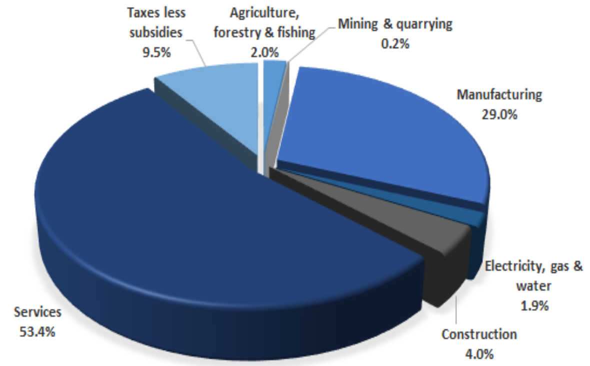
Meanwhile, the government started implementing the Three-Year Plan for Economic Innovation in February 2014. The plan, which focuses on: 1) public sector reforms; 2) promoting a creative economy; and 3) boosting domestic demand, is key to achieving an average annual growth pace of 4.0% over the medium term. Moreover, a more favourable outlook for global trade in light of the stronger US economy and persistently low global crude oil prices will further underpin private consumption. Meanwhile, rising contribution from the services sector is a critical factor in minimising the risks of a significant downturn of the economy. Nevertheless, the prospects of monetary normalisation in some advanced countries such as the US and UK, as well as prolonged weaknesses in the euro zone and economic slowdown in emerging economies, particularly China, will continue to pose downside risks to the South Korean economy.

Chart 1: Real GDP and real GDP growth



Source: CEIC, MARC Economic Research

Chart 2: South Korean economic structure (2014)



Source: CEIC, MARC Economic Research

Credible and proactive monetary policy

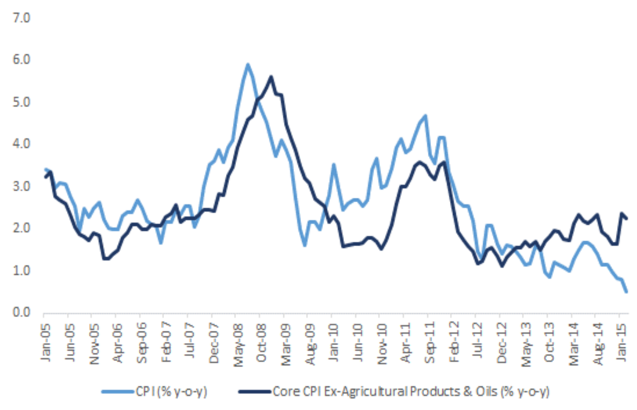
The BoK's monetary and macroprudential policy responses have been both credible and proactive. It has a good track record of dealing with past economic challenges such as escalating real estate prices prior to 2009 and the economic downturn during the GFC. For example, the BoK was instrumental in stabilising South Korea's financial market when it lowered its base rate five times between October 2008 and February 2009, bringing it down to 2% from 5.25%.

The central bank also has a good grip on inflation. After falling from a peak of 4.0% in 2011, inflation remains subdued, holding at 1.3% in 2014 for the second consecutive year. This has offered some policy space for the BoK to respond to weakening domestic demand; in the eight months through March 2015, it lowered the policy rate by a cumulative 75 bps to a record low of 1.75%. Effectively, official lending rates have drifted below 4.0% for the first time since 1999 in the six months through April 2015. As a result, overall lending has rebounded swiftly.

While there is likelihood that the headline inflation rate may continue to decelerate in the next couple of months, we do not foresee the deflationary threat persisting over the medium term because the growth trend of the core consumer price index (CPI) suggests sustained upward domestic prices. Overall, assuming that global crude oil prices recover in the second half of the year and stabilise between USD65 and USD75 per barrel, we foresee the inflation rate likely ranging between 1.0% and 1.5% in 2015, slightly higher than the central bank's forecast of 0.9%.

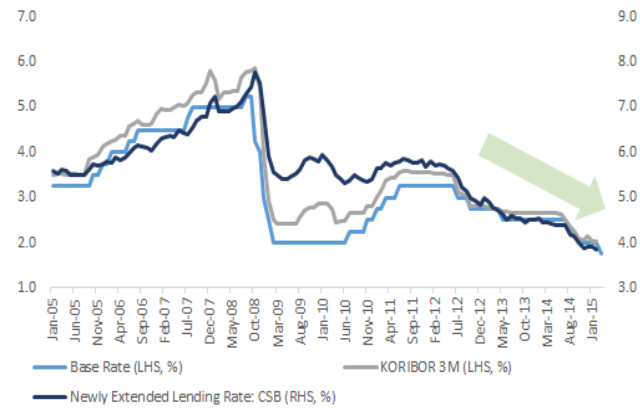
MARC feels that unless the economy falls into a recession – which is highly improbable at this juncture – the BoK is unlikely reduce its benchmark rate further given that it is already lower than during the GFC. Also, with a record high household leverage, the possibility of another rate cut is very limited, as further reductions in borrowing cost will cause household debt to escalate further. We believe the current monetary stance is appropriate given relatively benign consumer inflation and the uneven recovery of some advanced economies. Going forward, we do not foresee the policy rate moving too drastically away from the current level, despite the possibility of further capital outflows amid the increasing prospect of interest rates normalisation in the US.

Chart 3: Consumer and producer price indexes



Source: CEIC, MARC Economic Research

Chart 4: Interest rates



Source: CEIC, MARC Economic Research

Sound fiscal policies

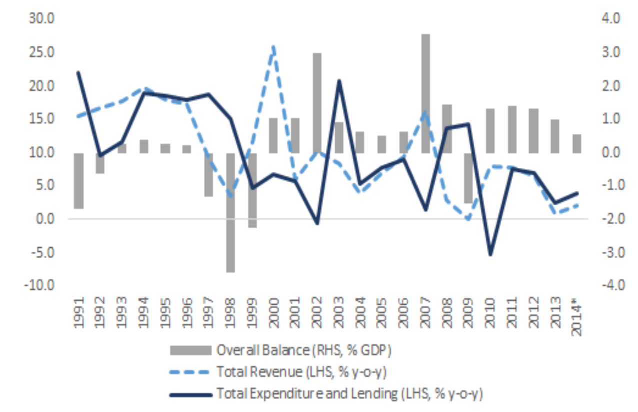
Fiscal policies in South Korea have been generally sound, and the government has a proven track record of keeping the budget mostly in surplus in most years. In 2014, the consolidated central government balance worsened slightly from the previous year, registering a smaller fiscal surplus of 0.6% of GDP, down from 1.0% of GDP previously. After excluding social security funds, the fiscal deficit widened to 2.0% of GDP (2013: -1.5% of GDP). While worsening overall balance is generally not a good thing, it reflects South Korea's expansionary fiscal policy stance adopted in early 2014 against the backdrop of weakening domestic demand and challenging external sector.

South Korea's overall government debt remains manageable; at 33.9% of GDP in 2014 (2013: 32.5%), it is well below the level for most advanced economies (OECD average in 2013: 84.7% of GDP). Meanwhile, contingent liabilities (debt guaranteed by the central government) remained minuscule in 2014 at only 2.0% of GDP (2013: 2.3%). On top of that, only 0.2% of total central government debt is short term, with the remainder at either medium or longer term. The structure of borrowings has also improved in that the government is keeping debt issuances domestic, thereby reducing exposure to foreign currency risk. In 2014, total external borrowings constituted merely 1.4% of total central government debt (2013: 1.7%), a significant improvement from a high of 18.4% in 2004.

Under its 2014-2018 National Fiscal Management Plan, the government pledges to adopt expansionary fiscal policies in the short term to aid recovery and to develop future growth engines. While government debt as a percentage of GDP is expected to increase to the mid-30% level in 2014-2018, it will remain below the level of most developed countries.

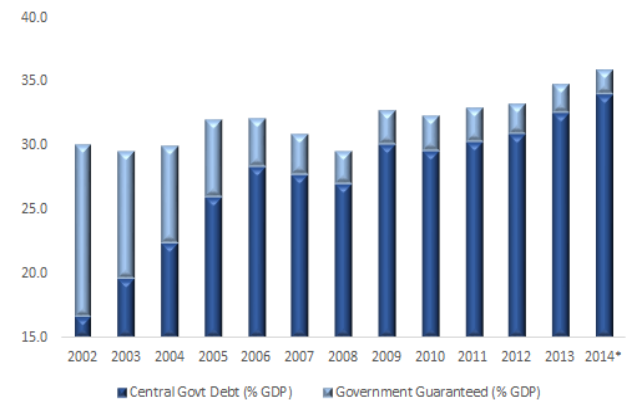
With economic growth expected to improve, overall government finances will likely remain in good shape; revenue growth will remain decent, and debt ratios sustainable, although increasing slightly. Judging from the past, historical prudence has helped provide the government with substantial fiscal space to approach the economy's problem flexibly. As such, we do not foresee the government's financial position to be a prime concern.

Chart 5: Central government finance



Source: CEIC, MARC Economic Research
*Note: * Preliminary figures*

Chart 6: Central government debt and guaranteed debt



Source: CEIC, MARC Economic Research
*Note: * Preliminary figures*

Improving external finances

South Korea's external finances have continued to improve in spite of a challenging external environment. In 2014, the CA surplus reached a record high of USD89.2 billion, up from USD81.1 billion in 2013. As a percentage of GDP, the CA surplus stood at a 16-year high of 6.3% in 2014 (2013: 6.2% of GDP). Post-GFC, the CA surplus averaged 4.2% of GDP in the five years through 2014, a stark improvement from an average of 1.4% of GDP in the five years preceding the GFC.

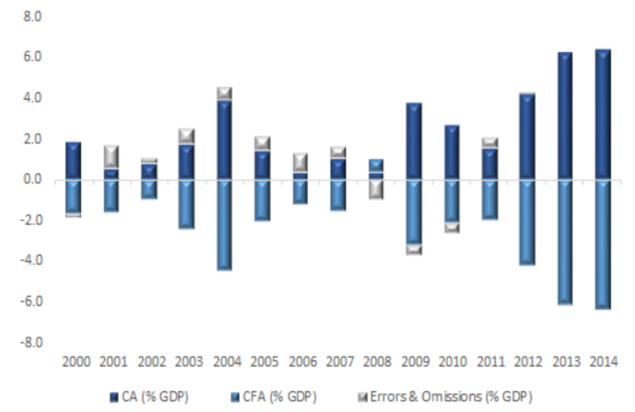
Also, for the first time in history, South Korea registered a positive net IIP in 2014, enhancing its position as a net creditor nation. As of 2014, its net IIP stood at USD81.9 billion or 5.8% of GDP (2013: –USD37.2 billion; -2.9% of GDP). South Korea's international reserve position has also increased in tandem, albeit rising slower than in the previous year (2014: 4.9%; 2013: 6.0%); it rose to USD363.6 billion as of end-2014, the seventh-largest in the world.

South Korea's external debt position has continued to improve; in 2014, the overall growth pace of external liabilities slowed to 0.5%, down from a 3.6% pace in the preceding year. The short-term portion has remained broadly stable, standing at less than 30% of total external debt for two consecutive years (2014: 27.1%; 2013: 26.4%); of the total, nearly 90% is held by the private sector. General government external debt, meanwhile, accounted for 15.3% of total external debt, with all borrowings long term in nature. As a percentage of GDP, total external debt stood at 30.2% in 2014, down from 32.5% in the preceding year.

Going forward, MARC is of the view that South Korea's external finances will remain commendably healthy. Its CA surplus is expected to widen in the short to medium term largely due to low global crude oil prices. On capital flows, we foresee increasing volatility over the short term in light of possible monetary tightening in the US and UK in 2015. However, the country's flexible exchange rate regime which has been in place since 1997, as well as its large net foreign asset position will act as important buffers against any potential shock arising from sudden volatile capital flows over the medium term.

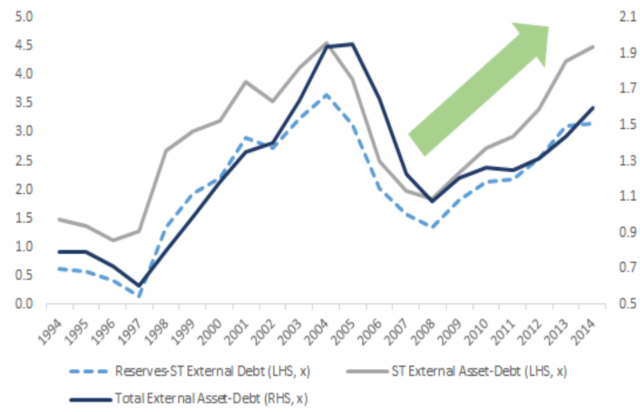
MARC also views the recent turnaround in the net IIP as a credit positive as this will further enhance its position as a net creditor nation and limit the impact of any renewed global financial volatility. On external debt, we are comforted by the country's improving debt profile; modestly low short-term obligations are more than matched by even larger short-term external assets. Moreover, its international reserves, at 3.2 times of short-term obligations and the seventh-largest in the world, should be adequate as a cushion against possible massive outflows of capital.

Chart 7: Balance of payments



Source: CEIC, MARC Economic Research

Chart 8: Reserves-ST external debt ratio and external asset-debt ratio



Source: CEIC, MARC Economic Research

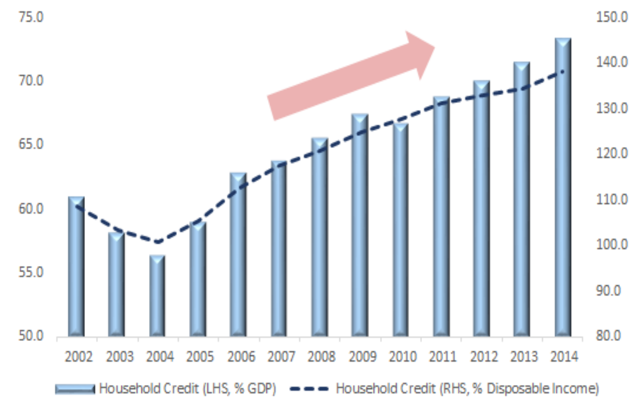
Major Challenges

High household leverage

MARC views with concern the accelerating growth of household leverage, although the pace has somewhat moderated compared with the period prior to the GFC (7.0% as against pre-GFC average of 9.5%). Total household debt, which includes loans extended by non-banks, other financial corporations and merchandise credits, reached a record high of KRW1,089.0 trillion in 2014, up by 6.6% from the preceding year (2013: 6.0%) and equivalent to 138.0% of household disposable income and 73.3% of GDP. This was partly due to cheap borrowing costs as well as easing measures introduced by the government to revive the stagnant housing market. Effective August 2014, the loan-to-value (LTV) ratio and debt-to-income ratio (DTI) were raised by 10 percentage points each to 70% and 60% across the board respectively, in spite of the risk of causing further deterioration of household balance sheets.

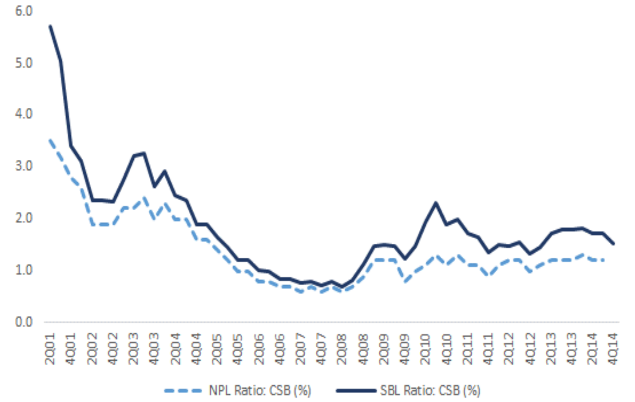
As South Korea has already had a history of overextended consumer borrowings, which led to a mini-crisis in the early 2000s, MARC foresees this segment as a potential source of financial vulnerability. However, given current low default rates, we do not expect any large hiccups to affect the stability of the banking system. Moreover, we note that the level of household financial assets remains adequate, at two times financial liabilities. Inclusive of properties, assets are five times larger than financial obligations. Also, recent FSC data shows that the household debt structure has continued to improve; specifically, 70% of borrowers are from high-income households and can afford debt repayment. Meanwhile, the quality of household mortgage loans has also steadily improved, as evidenced by the proportion of fixed-rate and fully amortised loans of banks' household mortgage loans, which climbed to 23.6% and 26.5% respectively in 2014 from a low of 0.5% and 6.4% respectively in 2010.

Chart 9: Household debt



Source: CEIC, MARC Economic Research

Chart 10: NPL and SBL ratios



Source: IMF WEO Database, MARC Economic Research

Persistent geopolitical concerns

Persistent geopolitical concerns arising from its proximity to North Korea is a downside risk. The Korean War ended in 1953 without any formal peace treaty; more than six decades later, the Korean Peninsula remains technically in a state of war, and tensions rise from time to time. The North Korean leader Kim Jong-un, in his New Year's speech this year, mentioned that he would be willing to engage in high-level summit talks with the South Korean government, though the prospect of that happening remains in question.

MARC is of the view that unification of the two Koreas remains unrealistic at the current juncture. However, we feel that there are possibilities of some short-term gains should the two engage in talks, particularly on issues of economic exchange, security and nuclear weapons.

Table 1: Selected economic indicators

	2009	*2010*	*2011*	*2012*	*2013*	*2014*
Real GDP Growth (%)	*0.7*	*6.5*	*3.7*	*2.3*	*2.9*	*3.3*
Consumer Price Index (%)	*2.8*	*2.9*	*4.0*	*2.2*	*1.3*	*1.3*
Current Account (% GDP)	*3.7*	*2.6*	*1.6*	*4.2*	*6.2*	*6.3*
Foreign Exchange Reserves (USD bn)	*270.0*	*291.6*	*306.4*	*327.0*	*346.5*	*363.6*
External Debt (% GDP)	*38.2*	*32.5*	*33.3*	*33.4*	*32.5*	*30.2*
External Assets (% GDP)	*46.0*	*41.2*	*41.5*	*44.0*	*46.7*	*48.1*
Government Fiscal Balance (% GDP)	*-1.5*	*1.3*	*1.4*	*1.3*	*1.0*	*0.6**
Government Debt (% GDP)	*30.1*	*29.5*	*30.2*	*30.9*	*32.5*	*33.9**
NPL Ratio (%)	*0.8*	*1.1*	*0.9*	*1.0*	*1.2*	*1.2***
Household Debt (% Disposable Income)	*124.8*	*127.7*	*131.3*	*133.1*	*134.2*	*138.0*
WEF Global Competitiveness Index (rank)	*19*	*22*	*24*	*19*	*25*	*26*

Source: BoK, FSC, CEIC, MARC Economic Research
*Note: * = Preliminary figures, ** = latest data as of 3Q2014*

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