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Country Risk Monitor

SOUTH KOREA

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In a nutshell

- South Korea’s solid macroeconomic fundamentals are supported by its status as a high-income, well-diversified economy. Its income per capita on a purchasing power parity (PPP) basis stands at USD36,612 in 2015 and ranks 33rd globally. The economy has been resilient, enjoying uninterrupted economic growth for 17 consecutive years, despite a relatively high degree of economic openness. While economic growth moderated to 3.6% in the six years through to 2015, its performance fared relatively better than its Organisation of Economic Co-operation and Development (OECD) peers which averaged at 1.9% during the same period. This was mainly attributed to the diversification of its economy, alongside a highly competitive industrial and manufacturing base. In fact, the economy weathered the Global Financial Crisis (GFC) effectively, registering a positive growth of 0.7% in 2009.

- South Korea’s external finances remained remarkably robust, despite a challenging external environment. The current account (CA) balance has been in surplus for 18 consecutive years, and improved further to a 17-year high of 7.7% of gross domestic product (GDP) in 2015. In addition, its positive net international investment position (IIP) strengthened to a record 14.2% of GDP in 2015, further enhancing its solid macroeconomic fundamentals and reflecting South Korea’s credibility in building strong external buffers in the face of heightened global financial volatility. Moreover, its high level of international reserves (3.4 times of short-term external debt) and substantial gross external assets (1.8 times of external debt), along with the country’s floating exchange rate regime, act as an important cushion against renewed global financial market turmoil over the near term.

- South Korean fiscal management remained prudent, as evidenced by sustained fiscal surpluses since the new millennium, save for 2009 during the GFC. While the government has pledged to adopt an expansionary fiscal stance in the short to medium term, we do not foresee South Korea’s fiscal soundness to be materially impacted, as past fiscal prudence enables the government to introduce countercyclical measures to support the economy. Indeed, we foresee it to remain broadly manageable and improve gradually, in line with its medium-term fiscal management plan. While we foresee government debt to increase to around 40% of GDP over the foreseeable future, it will remain sharply lower than that of other advanced economies (OECD’s average: 71.7% of GDP).

- While the economy remained relatively resilient, the prospects over the medium to longer term have been weighed by an array of structural challenges arising from, among other things, a rapidly aging population, lagging productivity and rising corporate vulnerabilities. The International Monetary Fund (IMF) estimates that South Korea’s potential economic growth has fallen to below 3.0% in 2015 from 7.0%-8.0% in the early 1990s, owing to declining contributions from labour, capital inputs and productivity. Nonetheless, we foresee the authorities’ strong commitment on structural reforms as a positive attribute. While some of the measures experienced limited progress due to the recent political gridlock, past experience of successful economic reforms suggest that the authorities would be able to sustain and improve growth performance over the medium to longer term.

- Geopolitical concerns due to South Korea’s exposure to North Korea remain a downside risk. This is in view of its longstanding conflict with the North Korean regime which could destabilise the economy in the event of a serious escalation of tension. While the likelihood of a reunification between South and North Korea remains relatively low at this juncture, a smooth and peaceful reconciliation over the longer term would benefit the economy through greater access to cheap labour and investment opportunities, despite large initial fiscal costs.

Table 1: Selected economic indicators

	2010	2011	2012	2013	2014	2015
Real GDP Growth (%)	6.5	3.7	2.3	2.9	3.3	2.6
Consumer Price Index (%)	2.9	4.0	2.2	1.3	1.3	0.7
Unemployment Rate (%)	3.7	3.4	3.2	3.1	3.5	3.6
Current Account (% GDP)	2.6	1.6	4.2	6.2	6.0	7.7
Net IIP (% GDP)	-12.0	-6.7	-7.7	-2.9	6.2	14.2
Foreign Exchange Reserves (USD bn)	291.6	306.4	327.0	346.5	363.6	368.0
Gross External Debt (% GDP)	32.5	33.3	33.4	32.4	30.1	28.7
Gross External Assets (% GDP)	41.2	41.5	44.0	46.6	48.4	52.1
Government Fiscal Balance (% GDP)	1.3	1.4	1.3	1.0	0.6	0.0
Government Debt (% GDP)	29.5	30.2	30.9	32.5	33.9	35.7
Household Debt (% Disposable Income)	127.7	131.3	133.1	133.9	136.4	143.7
WEF Global Competitiveness Index (rank)	22	24	19	25	26	26

Source: BoK, FSS, CEIC, WEF, MARC Economic Research.

Key Strengths

High income, well-diversified economy

South Korea's economic story continued to be impressive despite facing multiple headwinds and global challenges. It is Asia's fourth largest economy and is ranked 12th globally. Thanks to the rapid industrialisation and successful economic reforms since the 1960s, its income per capita on a PPP basis jumped nearly fivefold since 1990 to a high of USD36,612 in 2015. A member of the OECD, South Korea is now the 33rd wealthiest nation in the world, and is comparable to Japan (USD38,141) and New Zealand (USD36,135). Not surprisingly, the World Economic Forum continued to affirm South Korea's ranking at 26th place for the third consecutive year in its latest Global Competitiveness Index (GCI) 2016-17, attributed to its highly competitive and innovation-driven economy.

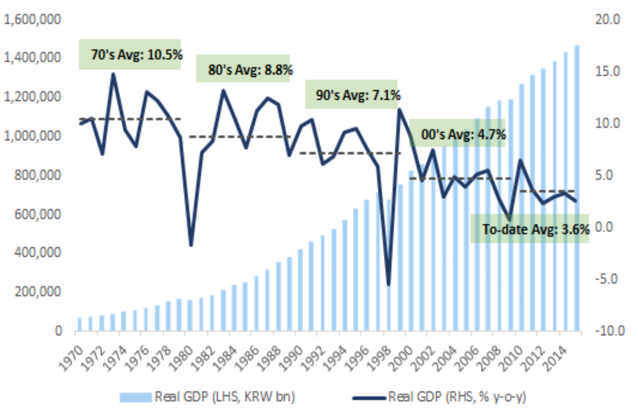
The economy remained resilient, despite a relatively high degree of economic openness, enjoying uninterrupted economic growth for 17 consecutive years, although at a slower pace in the post-GFC period. While economic growth moderated to 3.6% in the six years through to 2015, its performance fared relatively better than its OECD peers which averaged at 1.9% during the same period. This was mainly attributed to the diversification of its economy, alongside a highly competitive industrial and manufacturing base. In fact, the economy weathered the GFC effectively, registering a positive growth of 0.7% in 2009. The manufacturing sector consistently accounted for more than a quarter of total GDP over the past decade, significantly higher than the norm for advanced countries. The services sector, on the other hand, comprised 54% of total GDP over the past 10 years.

Being an open economy, South Korea is undoubtedly vulnerable to the vagaries of global trade conditions. In this regard, a contraction in global trade value in 2015, which was the worst since the GFC, has taken a toll on South Korean export performance. Real GDP growth eased to 2.6% in 2015 (2014: 3.3%), weighed down by a 1.2 percentage points reduction in net trade, the first negative contribution since 2010. Domestic demand, nevertheless, was resilient on the back of supportive fiscal and monetary policies, adding 2.6 percentage points to headline growth.

On the supply side, the manufacturing sector, which closely mirrors global demand, was hit the most in six years in 2015. Its growth fell to 1.3% in 2015, less than half of its pace in 2014 (2014: 3.5%), contributing a mere 0.4 percentage points (2014: 1.0 percentage point) to headline GDP growth. Similarly, the services sector grew at a slower pace of only 2.8% from 3.3% posted in 2014, adding 1.5 percentage points to overall economic growth (2014: 1.8 percentage points).

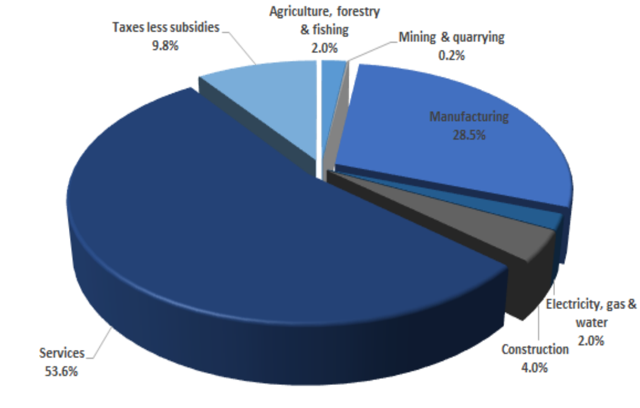
Going forward, MARC is of the view that, despite volatile external conditions, the economy will continue to be supported by both fiscal and monetary policies. Although the economy has been hit by a series of domestic and external shocks ranging from the Sewol ferry disaster in early 2014, the collapse in global crude oil prices in the latter part of the year and the outbreak of Middle East Respiratory Syndrome (MERS) in 2015, the authorities have managed to implement countercyclical measures to support the economy. These include higher fiscal spending and an accommodative monetary policy. As a result, real GDP growth picked up slightly to 2.9% in the first three quarters of 2016, backed by a steady recovery in domestic demand growth (YTD: 3.5%, 2015: 2.9%).

Chart 1: Real GDP and real GDP growth



Source: CEIC, MARC Economic Research

Chart 2: South Korean economic structure (2015)



Source: CEIC, MARC Economic Research

Remarkably robust external finances

South Korea's external finances remained remarkably robust, despite a challenging external environment. The CA balance has been in surplus for 18 consecutive years, after being mostly in deficit during its economic heyday prior to the Asian Financial Crisis (AFC) in 1998. In addition, its net creditor position continued to strengthen, which to a certain extent contributed to the accumulation of foreign exchange reserves. These have further enhanced its solid macroeconomic fundamentals and reflect South Korea's credibility in building strong external buffers in the face of heightened global financial volatility.

Post-GFC, the CA surplus widened to an average 4.7% of GDP in the six years through to 2015, a stark improvement from an average 1.5% of GDP in the six years prior to 2009. When compared with its OECD peers, South Korea's CA balance was 3.8 percentage points higher than the former in the six-year period post-GFC (OECD countries: 0.9% of GDP). In 2015 alone, the CA surplus swelled to a 17-year high of 7.7% of GDP (2014: 6.0%). As one of the largest global net oil importers, the persistently low global crude oil prices have helped improve its terms-of-trade, offsetting weaker export demand.

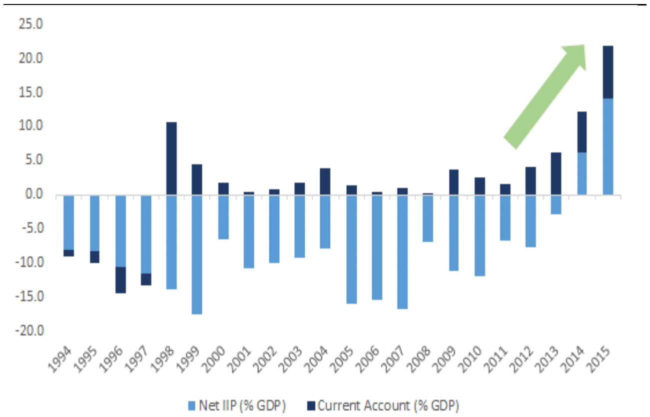
The first ever positive net international investment position (IIP) in 2014 which continued to strengthen in 2015 further limits the country's vulnerability to external shocks. Its net IIP stood at a whopping 14.2% of GDP, an increase by 8.0 percentage points from the preceding year (2014: 6.2%). While overall asset growth has eased to 4.9% in 2015 (2014: 11.8%), the weakest since 2008, the consecutive decline in overall liabilities (2015: -5.5%, 2014: -1.0%) has helped contribute to the bulk increase in net asset positions. South Korea's international reserve position, which is ranked the sixth largest in the world, has also increased in tandem to USD368.0 billion as of end-2015 (2015: 1.2%, 2014: 4.9%).

In addition, its relatively low gross external debt of 28.7% of GDP in 2015 was more than matched by even larger gross foreign assets (2015: 1.8 times of external debt), and compares favourably among its OECD peers. More importantly, the structure of the debt has continued to improve, with the short-term portion remaining less than 30% of total external debt since 2013 (2015: 27.1%, 2015: 27.4%). The private sector comprised about three-quarters of the borrowings, of which 31.1% of the total were short-term debt. The general government sector, meanwhile, accounted for 16.5% of total external debt, most of which (96.4%) were long term in maturity.

Looking ahead, MARC is of the view that South Korea's external balance sheet will continue to remain exceptionally solid, underpinned by sizeable CA surplus, strong positive net IIP position and high foreign exchange reserves. The CA surplus, however, is expected to moderate in the medium term, if the structural reforms manage to result a sustainable recovery in domestic demand and improve lagging productivity. In addition, a reversal in terms of trade, coupled with slower growth from China, its largest trading partner, will exert downward pressure on South Korea's nominal trade balance over the near to medium term.

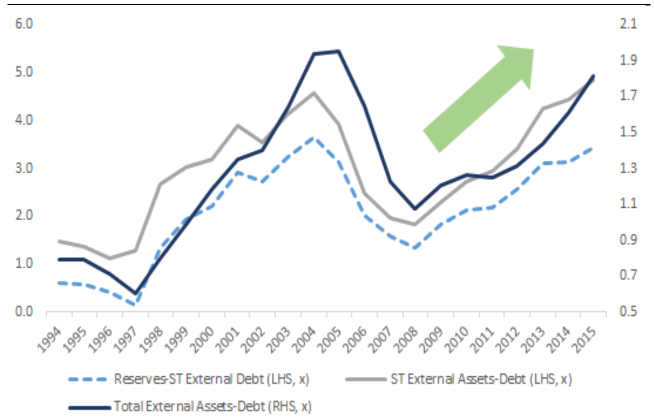
Nevertheless, with ample net foreign assets, South Korea will be in a better position to guard against any potential shock as a result of greater financial market volatility over the short to medium term. While total asset growth is expected to moderate over the medium term in tandem with the moderation in CA surpluses, it will remain exceptionally robust relative to its advanced countries and OECD peers. MARC also views the continued improvement in its net IIP position will further enhance its position as a net creditor nation and limit its vulnerability against renewed global financial market turmoil. Its high level of international reserves, at 3.4 times of short-term external debt and ranked the sixth-largest in the world, coupled with the country's floating exchange rate regime should act as an important cushion against possible massive outflows of capital over the near term.

Chart 3: Current account and net IIP as % GDP



Source: CEIC, MARC Economic Research

Chart 4: Reserves-ST external debt ratio and external assets-debt ratio



Source: CEIC, MARC Economic Research

Prudent fiscal management

South Korean fiscal management continued to remain prudent, as evidenced by sustained fiscal surpluses since the new millennium, save for 2009 during the GFC. The debt level, meanwhile, remained relatively low by global benchmarks, allowing the government to adopt an expansionary fiscal stance over the past few years in light of weakening domestic demand and a challenging external environment.

In 2015, the government registered a balanced budget (0.0% of GDP), down from a surplus of 0.6% of GDP in the preceding year. While that marked a fourth consecutive year of a worsening fiscal balance, it largely reflects the government's intensive efforts to jumpstart the economy. In the six-year period post-GFC, the overall fiscal surplus stood at 0.9% of GDP, down by 0.4 percentage points from its average in the six-year period prior to 2009. In particular, government expenditure growth more than doubled to 8.6% in 2015 (2014: 4.0%), the strongest pace since the GFC in 2009, owing to higher allocations meant to stimulate the economy. Following a similar trend, government revenue growth nearly tripled to 5.7% (2014: 2.1%), thanks to higher taxation receipts which accounted for about two-thirds of total revenue.

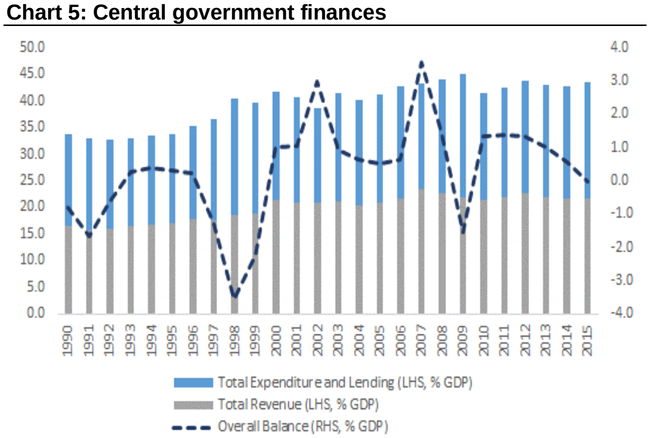
The central government debt, meanwhile, sustained at a relatively low level despite its increasing trend in recent years. It stood at 35.7% of GDP in 2015 (2014: 33.9% of GDP), well below the level for most of the advanced economies (OECD's average: 71.7% of GDP in 2015). Similarly, its contingent liabilities (debt directly guaranteed by the central government) remained minuscule at only 1.7% of GDP in 2015, and in fact has fallen consecutively from a cyclical high of 2.8% of GDP in 2010. Of total central government debt, only 0.2% is short term, while the remainder are either medium- or longer-term maturities. The structure of borrowings has also improved as the government has kept the practice of issuing domestic debt, thereby reducing its exposure to foreign currency risks. Total external borrowings constituted merely 1.3% of total central government debt (2014: 1.4%), a significant improvement from an average of 15.9% in 2002-2004.

For Budget 2017, the government is trying to ensure fiscal soundness, while maintaining its expansionary fiscal stance to deal with rising economic and social challenges. Accordingly, the government has proposed to increase spending by 3.7% from the 2016 Budget while expecting the fiscal balance and government debt to improve steadily compared with the 2015-2019 Fiscal Management Plan. The budget will focus on six key thrusts, namely 1) creating jobs for the future generation; 2) developing new growth engines; 3) increasing competitiveness of Small and Medium Enterprises (SME), startups and local economies; 4) raising birth rates and strengthening the welfare programmes tailored to specific needs; 5) enhancing national defence capability and improving public safety; and 6) improving spending efficiency.

Looking ahead, while the government has pledged to adopt an expansionary fiscal policy in the short to medium term, we do not foresee South Korea's fiscal soundness to be materially impacted, as past fiscal prudence would enable the government to introduce countercyclical measures to support the economy. Although a slight deterioration in the overall fiscal balance is widely expected, it will remain manageable and improve gradually over the short to medium term, in line with its medium-term fiscal management plan. In addition, the proposal to enact a fiscal soundness law will further enhance its already credible fiscal management framework.

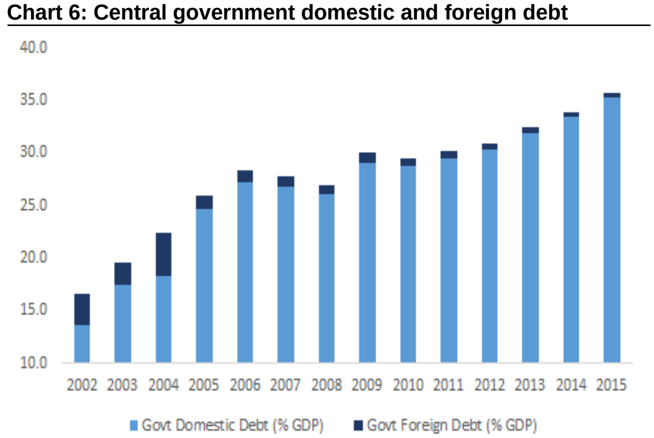
On the debt profile, MARC is of the view that the level will steadily increase to around 40% of GDP over the near to medium term, but will remain sharply lower than the average of advanced economies and OECD peers. South Korea's good track record of over performance in its fiscal position over the past two decades is a strong indication of the credibility of its fiscal policies and management. Given the considerable fiscal space, the government has ample flexibility in its policy options in the near term. As such, we do not foresee the government's financial position to be a prime concern.

Chart 5: Central government finances



Source: CEIC, MARC Economic Research

Chart 6: Central government domestic and foreign debt



Source: CEIC, MARC Economic Research

Major Challenges

Array of structural challenges

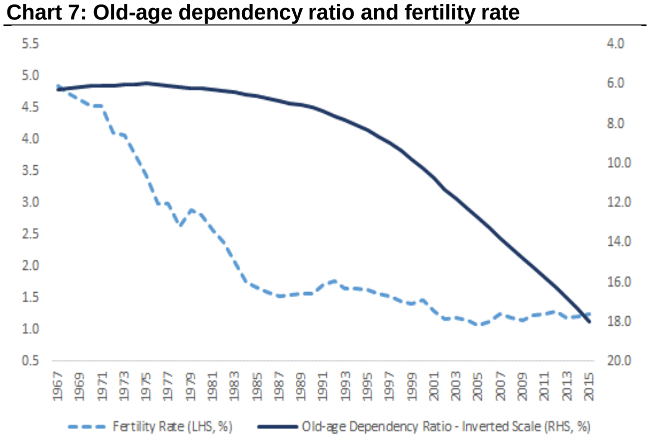
While the economy continued to remain resilient, the prospects over the medium to longer term have been clouded by an array of structural challenges arising from, among other things, a rapidly aging population, lagging productivity and rising corporate vulnerabilities. The IMF estimates that South Korea's potential economic growth has fallen to below 3.0% in 2015 from 7.0%-8.0% in the early 1990s, due largely to declining contributions from labour, capital inputs and productivity.

In particular, the old-age dependency ratio has increased exponentially by 0.5 percentage points per annum since 2000 to a high of 18.0% in 2015 (early 1990s: +0.1 percentage point), which calls for higher social commitment going forward. South Korea's fertility rate of 1.2% in 2015, which remained the lowest in the world, will continue to suppress labour supply growth and could pose serious repercussions for domestic demand. Labour productivity in the services sector was half that of the manufacturing sector and about 45% of OECD's services productivity. While corporate balance sheets remained healthy at the consolidated level, some firms from export-oriented industries such as shipbuilding, shipping and petrochemicals are facing a worsening operating environment and are in need of restructuring. This will further constrain productivity growth and pose short-term downside risks to the economy.

It is also worth noting that the benign domestic price pressures over the past few years can be partly explained by a structural shift in the demographic profile. The aging population has slowly capped the growth of domestic demand and subsequently added to the downward pressure on domestic prices. A study by the IMF shows that South Korea's rapidly aging population may contribute to a 0.3 percentage point reduction in consumer inflation over the next five years, in the absence of any structural reforms implemented by the authorities. Meanwhile, its persistently large CA surplus in recent times was also a reflection of underinvestment and weak consumption, which to a certain extent can be attributed to its rapidly aging demographic profile.

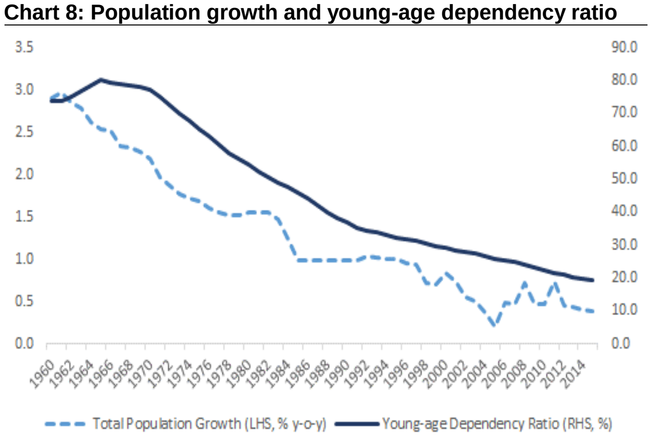
Nevertheless, MARC views the authorities' strong commitment on structural reforms as a positive attribute. The government has laid out a comprehensive reform plan, which include among others: (1) labour market reforms; (2) enhancement of social safety nets; (3) reforms in state-owned enterprises (SOE) and the financial sector; (4) improvement in an already impressive educational system; (5) facilitation of corporate restructuring; and (6) development of a creative economy. While some of these measures have experienced limited progress due to the recent political gridlock, past experiences seem to suggest that the authorities would be able to sustain and lift up growth performance over the medium to longer term.

Chart 7: Old-age dependency ratio and fertility rate



Source: CEIC, MARC Economic Research

Chart 8: Population growth and young-age dependency ratio



Source: CEIC, MARC Economic Research

Persistent geopolitical concerns

Geopolitical concerns due to South Korea's exposure to North Korea remain a downside risk. This is in view of its longstanding conflict with the North Korean regime which could destabilise the economy in the event of a serious escalation of tensions. The Korean War ended in 1953 without any formal peace treaty, which left the peninsula remaining in a technical state of war. As such, tensions rise from time to time, often due to provocations and threats by the Northern regime. In February 2016, South Korea's government directed Kaesong Industrial Complex, an industrial park operated as a collaborative economic development with North Korea, to shut its operations in response to North Korea's missile launch and continued nuclear tests.

Notwithstanding this, we do not rule out the possibility of reunification with its northern neighbour over the longer term, although chances of a reconciliation remain limited at this juncture. A smooth and peaceful reconciliation over the longer term will benefit the economy through greater access to cheap labour and investment opportunities, despite large initial fiscal costs.

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