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Country Risk Monitor

SOUTH KOREA

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In a nutshell

- South Korea's economic story has been impressive, with rapid industrialisation having successfully transformed one of the poorest nations in the 1960s to the world's 34th wealthiest and 11th largest in 2016. The economy has proven to be resilient, despite its relatively high degree of economic openness. It was one of the few advanced economies that avoided the Global Financial Crisis (GFC) and enjoyed 18 consecutive years of economic growth since the Asian Financial Crisis (AFC) in 1997/1998. This can be attributed to the significant diversification of its economy, underpinned by a highly competitive industrial and manufacturing base. While real gross domestic product (GDP) growth has slowed to 3.5% per annum (p.a.) in the post-GFC period (pre-GFC: 4.7% p.a.), its performance remained remarkably better than the 2.1% annual pace for the Organisation of Economic Co-operation and Development (OECD) countries.

- South Korea's external buffer remained remarkably strong, solidifying its macroeconomic fundamentals. The current account (CA) surplus of the balance of payments is large by advanced countries standards, and its net creditor position as well as ample international reserves provide a substantial buffer against potential external shocks. Post-GFC, the CA surplus averaged at 5.0% of GDP, outperforming its OECD peers by a whopping 3.9 percentage points. The economy's net international investment position (IIP) which turned positive in 2014 has since continued to improve, standing at a record 19.7% of GDP in 2016. Meanwhile, its high level of international reserves, at 3.5 times of short-term external debt, alongside the country's floating exchange rate regime acts as the first line of defense against any possible massive outflows of capital over the near to medium term.

- The strength of the economy is also underpinned by its good track record of prudent fiscal management. The country had enjoyed 16 successive years of fiscal surpluses, save for 2009 during the GFC, averaging at 1.2% of GDP. The debt level remained relatively low (2016: 36.1% of GDP) by global average, though it has continued to increase in recent years. In view of the ample fiscal space, it is not surprising to see that the authorities have continuously adopted an expansionary fiscal stance to support the economy without significantly derailing its fiscal metrics. As such, MARC does not foresee the government's balance sheet to be a prime concern. Indeed, it has ample flexibility in its policy options to support growth over the foreseeable future.

- While the economy has remained remarkably resilient, the country's structural issues are weighing on its long-term economic potential. The population is rapidly ageing, while labour productivity is lagging, particularly in the non-tradeable sector. Not surprisingly, the International Monetary Fund (IMF) estimates that South Korea's potential growth has fallen to below 3% in 2015, from as high as 8.0% in the early 1990s. It is important to note that an ageing population bears a significant implication on growth, inflation, CA and fiscal balances. On these, MARC takes comfort from the authorities' strong commitment to implement structural reforms. In spite of the ongoing parliamentary 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.

- Persistent geopolitical concerns related to its Northern neighbour remain a major weakness for South Korea's economic risk profile. In spite of heightening tensions since early this year, MARC expects an outright military conflict will likely be averted, in view of its adverse impact, be it global or regional. Indeed, any persistent provocations by the Northern regime will likely result in greater sanctions by the global community, something which we believe the North Korean leader will try to avoid over the longer term. In this regard, the possibility of a reunification between the two Korean countries remain extremely low, although a smooth and peaceful reconciliation over the longer term will benefit the economy through greater access to cheap labour and vast investment opportunities, despite large initial fiscal costs.

Table 1: Selected economic indicators

	2011	2012	2013	2014	2015	2016
Real GDP Growth (%)	3.7	2.3	2.9	3.3	2.8	2.8
Consumer Price Index (%)	4.0	2.2	1.3	1.3	0.7	1.0
Unemployment Rate (%)	3.4	3.2	3.1	3.5	3.6	3.7
Current Account (% GDP)	1.6	4.2	6.2	6.0	7.7	7.0
Net IIP (% GDP)	-6.7	-7.7	-2.9	6.0	14.8	19.7
Foreign Exchange Reserves (USD bn)	306.4	327.0	346.5	363.6	368.0	371.1
Gross External Debt (% GDP)	33.3	33.4	32.4	30.1	28.6	27.0
Gross External Assets (% GDP)	41.5	44.0	46.6	48.0	52.1	55.6
Government Fiscal Balance (% GDP)	1.4	1.3	1.0	0.6	0.0	1.0
Government Debt (% GDP)	30.2	30.9	32.5	33.9	35.6	36.1
Household Debt (% Disposable Income)	131.3	133.1	133.9	136.4	142.9	153.4
WEF Global Competitiveness Index (rank)	24	19	25	26	26	26

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

Key Strengths

Well-diversified high income economy

South Korea's economic story has been impressive, with rapid industrialisation having successfully transformed one of the poorest nations in the 1960s to the world's 34th wealthiest and 11th largest in 2016. A member of the OECD, South Korea's GDP per capita adjusted to purchasing power parity (PPP) terms has climbed by fivefold since 1990 to USD37,730 in 2016, 17 times larger than it was more than three decades ago.

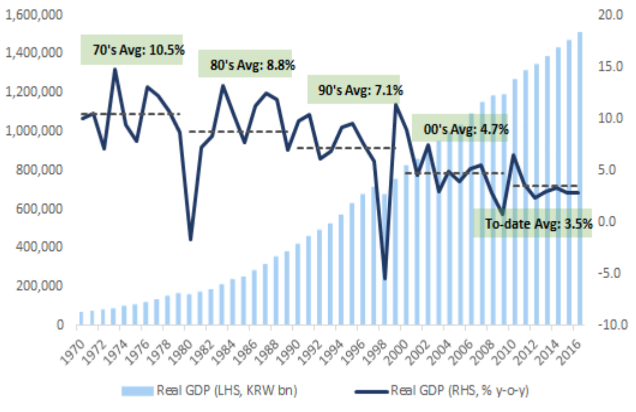
The economy has proven to be resilient in the face of global uncertainties, despite the country's relatively high degree of economic openness. It was one of the few advanced economies that avoided the GFC effectively, and enjoyed 18 consecutive years of economic growth since the AFC in 1997/1998. While real GDP growth has slowed to 3.5% p.a. in the post-GFC period (pre-GFC: 4.7% p.a.), its performance remained remarkably better than the 2.1% annual pace for OECD countries. This can be attributed to the significant diversification of its economy, underpinned by a highly competitive industrial and manufacturing base. The manufacturing sector, for instance, accounted for 28.4% of GDP in 2016, and contributed about 30% of headline economic growth in the past 10 years, significantly higher than the norm for matured economies. The services sector, on the other hand, accounted for 53.3% of total output in 2016.

The economy continued to cruise smoothly in 2016, growing 2.8% from a year earlier, the same as in the preceding year. Supportive fiscal and monetary policies have effectively underpinned domestic demand, weathering the persistent weakness at the external front. Domestic demand growth strengthened to 3.6% in 2016 (2015: 3.2%), the strongest since 2010, adding 3.4 percentage points to headline growth. Net exports, on the other hand, remained in negative territory for a second year, the first such stretch since the 1999-2000 period, subtracting 1.0 percentage point from GDP growth.

On the supply side, the services sector evidently took a hit from heightening global financial uncertainties, as slower financial and insurance activities (2016: 2.3%, 2015: 6.7%) dragged down growth of the services sector to 2.3% from 2.8% in the preceding year. The manufacturing sector, meanwhile, recorded slightly faster expansion of 2.3% during the year (2015: 1.8%), on the back of mild gains in overseas demand.

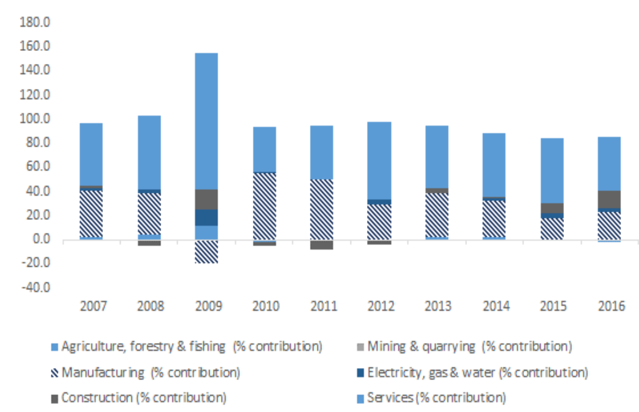
Going forward, MARC feels that the economy will remain in good shape, underpinned by both pre-emptive fiscal and monetary policies. Indeed, past countercyclical measures had effectively supported the economy in facing multiple headwinds. Furthermore, a more even global economic recovery and the recent improvement in the country's relationship with China over the Terminal High Altitude Area Defence (THAAD) issue will likely provide a significant short-term boost to the economy.

Chart 1: Real GDP and real GDP growth



Source: CEIC, MARC Economic Research

Chart 2: Sectoral contribution to headline GDP growth



Source: CEIC, MARC Economic Research

Substantial external buffer

South Korea's external buffer remained remarkably strong, solidifying its macroeconomic fundamentals. The CA surplus of the balance of payments is large by advanced countries standards, and its net creditor position as well as ample international reserves provide substantial buffer against any potential external shocks.

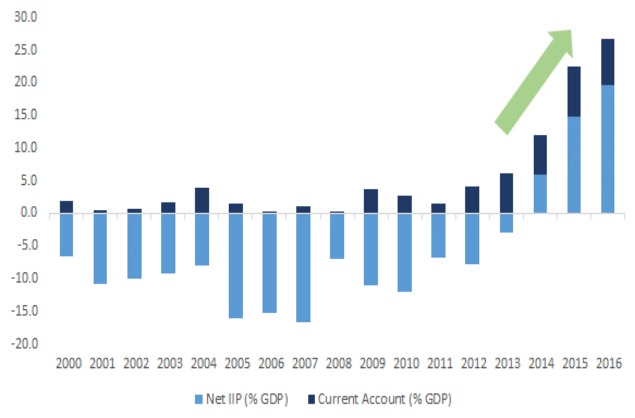
Post-GFC, the CA surplus averaged at 5.0% of GDP, significantly stronger than the 1.8% of GDP recorded in the seven years through 2009. South Korea outperformed its OECD peers by a whopping 3.9 percentage points in the seven years since 2010. In 2016, the CA surplus moderated slightly, but remained remarkably large at 7.0% of GDP, a decline by 0.7 percentage point from the preceding year. This is mostly due to the lacklustre global trade performance during the year, as evidenced by a 4.2% decline in the goods and services balance in 2016 (2015: +26.0%), the first drop since 2011.

The economy's net IIP which turned positive in 2014 has since continued to improve, standing at a record 19.7% of GDP in 2016. This represents a 4.9 percentage points increase compared to the preceding year, reflecting on the country's ability to build strong external buffers amid lingering global uncertainties. Moreover, the declining trend of its relatively low gross external debt has been accompanied by the continued rise in gross external assets, doubling its size over the former. Relative to the country's output, South Korea's net external assets in debt instruments rose to 28.6% of GDP in 2016, 4.2 times larger than it was a decade earlier. Significantly, the short-term external assets to debt ratio rose to a new high of 5.1 times in 2016 (2015: 5.0 times), further limiting South Korea's vulnerability against short-term external shocks.

Looking ahead, MARC expects South Korea's external position to remain robust, backed by a large CA surplus, strong positive net IIP position and ample foreign exchange reserves. Having said that, the CA surplus is anticipated to moderate slightly, in line with the slight recovery in domestic demand and improving productivity. Meanwhile, the continuing recovery in global trade momentum will ultimately be positive to its nominal trade balance, helping the country weather the uncertainties associated with US protectionism trade policies.

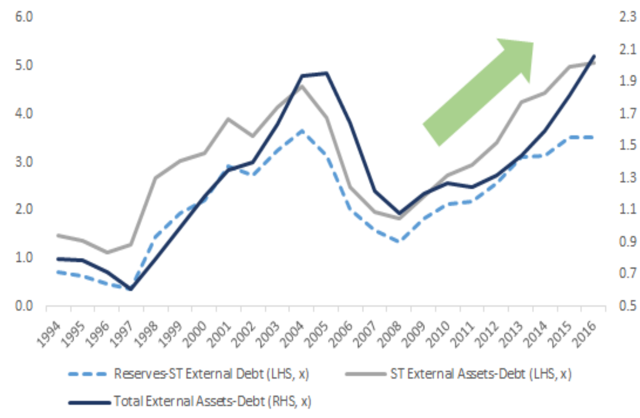
With ample net foreign assets, MARC views that South Korea is in a better position to guard against any potential shocks. Its high level of international reserves, at 3.5 times of short-term external debt, alongside the country's floating exchange rate regime will act as the first line of defense against any possible massive outflows of capital over the near to medium 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

The strength of the South Korean economy is also underpinned by its track record of prudent fiscal management. The country enjoyed 16 successive years of fiscal surpluses, save for 2009 during the GFC, averaging at 1.2% of GDP since the new millennium. Its debt level, meanwhile, has been relatively low by global average, though it has continued to increase in recent years. In view of the ample fiscal space, it is not surprising to see that the authorities have continuously adopted an expansionary fiscal stance to support the economy without significantly derailing its fiscal metrics.

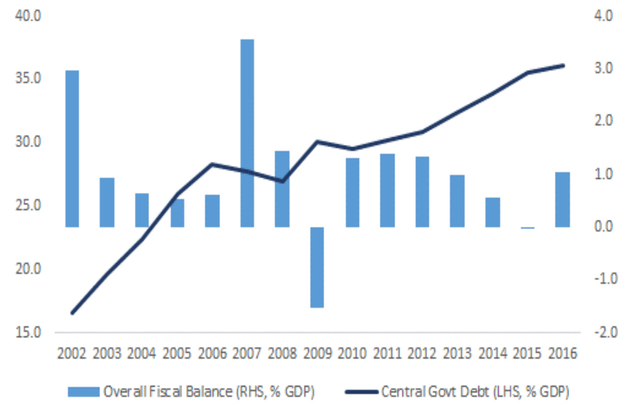
In 2016, the overall fiscal balance remained in the black, registering a surplus of 1.0% of GDP from a balanced budget in the preceding year. In particular, the 9.5% increase in total revenue more than offsets the 4.4% rise in total outlays. About 77% of the increase in revenue can be explained by an 11.3% rise in taxation receipts, marking the most increase in taxation since 2007. Meanwhile, a more targeted fiscal approach has evidently helped trim expenditure growth from a cyclical high of 8.6% in 2015.

The central government debt which stood at 36.1% of GDP in 2016 (2015: 35.6%) has remained moderately low despite its increasing trend in recent years. Notably, the level compared favourably against OECD peers' average government debt of 69.6% of GDP. More importantly, 98.9% of the debt was sourced domestically, and was long-term in nature (99.7% of total government debt), safeguarding it from foreign currency and maturity risks. Similarly, its contingent liabilities (debt directly guaranteed by the central government) remained minuscule, standing at a mere 1.5% of GDP in 2016, sharply down from a peak of 13.4% of GDP in 2002.

It is worth noting that the policy approach of the new administration has somewhat shifted from its predecessor, focusing more on supply-side measures to aid job creation and boost income growth. That said, the long-term economic goal remains intact, which is to revive potential growth in a sustainable manner. Accordingly, the government proposed a 7.1% increase in spending in Budget 2018, prioritising three key policies, namely 1) to successfully implement the new administration's economic policies; 2) to carry out strong fiscal restructuring; and 3) to pursue innovation in fiscal management. Offsetting this is the expectation of a 7.9% increase in total revenue in 2018, hence keeping the fiscal balance in surplus.

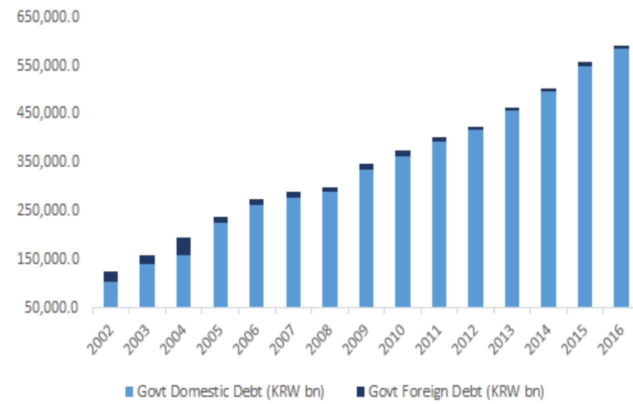
Looking ahead, MARC anticipates South Korea's fiscal metrics to remain in good health, despite the ongoing fiscal expansionary policy over the near to medium term. Nevertheless, the debt profile is expected to trend higher over the near to medium term, but will remain sharply lower than the average of advanced economies and OECD peers. Given the considerable fiscal space, MARC does not foresee the government's balance sheet to be a prime concern. Indeed, it has ample flexibility in its policy options to support growth over the foreseeable future.

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

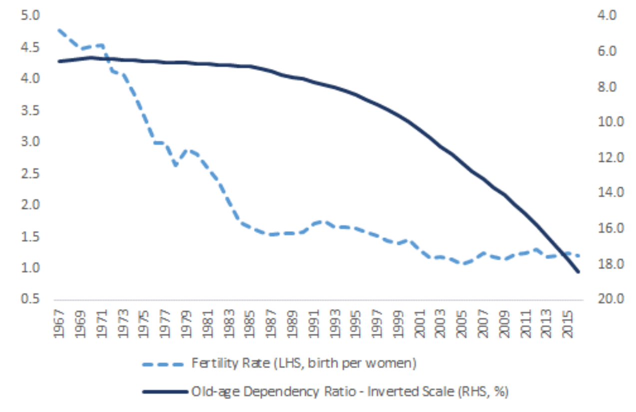
While the economy remains remarkably resilient, the country's structural issues are weighing on its long-term economic potential. The population is rapidly ageing, while labour productivity is lagging, particularly in the non-tradeable sector. Not surprisingly, the IMF estimates that South Korea's potential growth has fallen to below 3% in 2015, from as high as 8.0% in the early 1990s, amid falling contributions from labour, capital inputs and productivity.

It is important to note that the ageing population bears a significant implication on growth, inflation, CA and fiscal balances. Evidently, the old-age dependency ratio is rising at an exponential rate (early 1990s: +0.1 percentage point, 2014-2016: +0.7 percentage point), while its fertility rate of 1.2 births per women, which is the world's lowest, is suppressing labour supply growth. Moreover, the expected decline in labour force, combined with the ongoing shift of labour from manufacturing to services, with the latter's productivity measuring half of the former, will make it difficult for the economy to maintain the current growth pace over the longer term.

In addition, the subdued domestic price pressures over the past few years can be partly explained by the changes in the demographic structure. In particular, the ageing population has, in fact, discouraged investment and consumption, which subsequently exerted downward pressure on underlying domestic prices. A study by the IMF showed that South Korea's ageing population has contributed about 0.2 percentage point to the cumulative decline in inflation over the 2012-2015 period. In the absence of any structural reforms, the international lender noted that it may contribute to a 0.3 percentage point reduction in headline inflation over the next five years. Meanwhile, the country's persistently large CA surplus in recent years was also a reflection of underinvestment and weak consumption, due in part to its structural challenges.

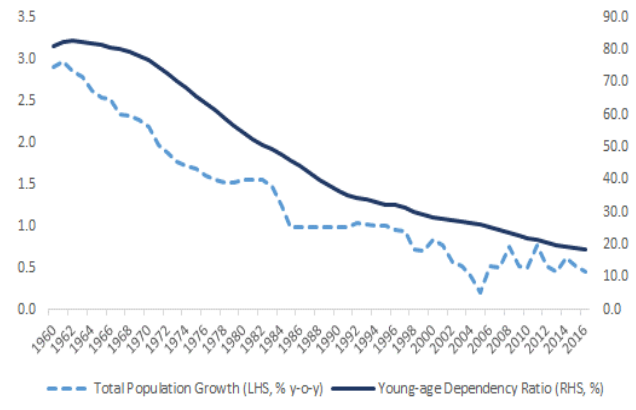
Notwithstanding this, MARC takes comfort from the authorities' strong commitment to implement structural reforms. The new administration has recently laid out new economic policies that will be based on a sustainable growth path via four important strategies, namely: (1) wage-led growth; (2) job creation; (3) fair competition; and (4) growth through innovation. While these policy measures have somewhat shifted from the prior reforms plan introduced by the previous administration, the overall intention remains broadly unchanged. In particular, they are meant to revive long-term growth potential and promote socially-inclusive growth.

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

Persistent geopolitical concerns related to its Northern neighbour remain a major weakness for South Korea's economic risk profile. Technically, the Korean peninsula remains in a state of war as the Korean War in 1953 ended without any formal peace treaty. This has fuelled tensions from time to time, often due to provocations and threats by the Northern regime.

Indeed, tension in the Korean peninsula has heightened considerably since early this year, largely due to escalating rhetoric from both North Korea and the new US administration over the former's continuous missile launch and nuclear tests. This has led to the deployment of the US-built THAAD system by the South Korean authorities, which has provoked economic sanctions from China, who argued that the anti-missile system represents a security threat to its border. These sanctions, which include a travelling ban to South Korea and, to a certain extent, harassment of South Korean businesses established in China, have finally ended in early November 2017 in a bid to improve economic ties between the two countries.

Having said that, MARC expects an outright military conflict to be averted, in view of its adverse impact, be it global or regional. Indeed, any persistent provocations by the Northern regime will likely result in greater financial and economic sanctions by the global community, something which we believe the North Korean leader will try to avoid over the longer term. In this regard, the possibility of a reunification between the two Korean countries remained extremely low, although a smooth and peaceful reconciliation over the longer term will benefit the economy through greater access to cheap labour and vast investment opportunities, despite large initial fiscal costs.

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