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SOUTH KOREA: Macroeconomic Update

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In a nutshell

- The South Korean economy is facing challenging times. According to the Bank of Korea's advance estimate of the gross domestic product (GDP) growth for 3Q2019, the economy expanded 2.0% y-o-y, unchanged from the previous quarter. Growth was mixed across key expenditure components. Thus far, the growth pace in the first three quarters of this year had come in lower than those in the previous year. With downside risks outweighing upside ones, South Korea's growth momentum should remain firmly on a downtrend. Full-year GDP growth in 2019 will very likely come in lower than the government's forecast range of 2.4% to 2.5%, and even the Bank of Korea's 2.2%.

- In July and October, the Bank of Korea cut its policy interest rate by 25 basis points each. Currently at 1.25%, the base rate matches the record low over the June 2016 – October 2017 period. While the first cut was to support growth, the second was prompted in part by deflationary concerns. In September, the consumer price index fell 0.4% y-o-y, the first time since data releases began in 1965. The producer price index (PPI) also fell; marking the third consecutive month of decline, its 0.7% y-o-y fall is feeding concerns that this may lead to a prolonged state of weak consumer prices.

- South Korea has substantial fiscal space to support growth given that the government is a net creditor. Meanwhile, the government's debt-to-GDP ratio remains enviably low at below 40%. As such, government spending, based on the recent trend, will likely become more aggressive and remain the main support of growth. For the 2020 budget, the government has proposed its most aggressive budget spending plan since the Global Financial Crisis. The planned total expenditure of 513.5 trillion won (USD423.5 billion) is up 8.0% (excluding the supplementary budget) from this year. Depending on how the growth situation pans out, a supplementary budget could be forthcoming.

- South Korea's external balance sheet remains robust. The latest available data show the current account (CA) surplus coming in at USD5.3 billion in August. For full year 2019, the government expects it to come in at USD60.5 billion (2018: USD76.4 billion). If not for weak domestic demand and private investment, South Korea's external performance could be facing more pressure. Going forward, pressure should build up from, besides higher government spending to support the economy, a rapidly ageing population. In any case, South Korea has substantial external buffers. For example, its foreign exchange reserves, standing at USD403.3 billion as of end-September, are ranked among the top-ten largest in the world.

DEVELOPMENTS AND OUTLOOK

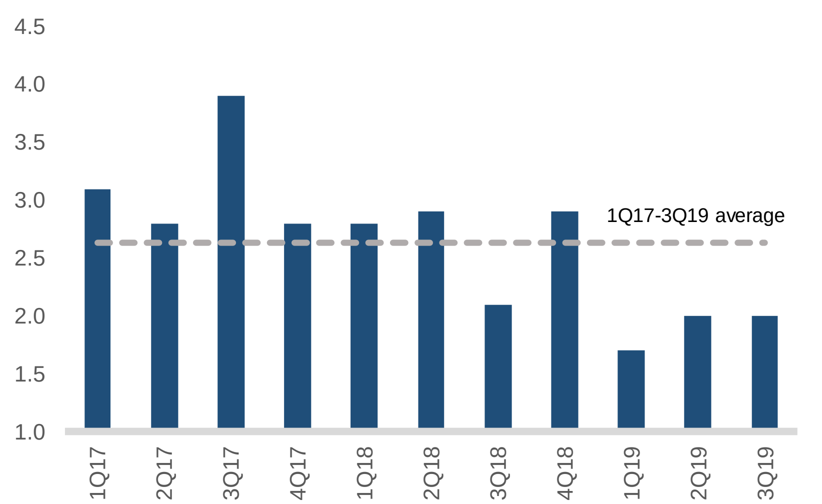
Economic growth remains on downtrend

- South Korea faces a difficult economic environment. On the domestic side, the semiconductor industry, a key sector, is in a cyclical downturn. On the external side, the US-China trade war continues to take its toll on the domestic economy. Even without the trade war, China – South Korea's largest export market – has been slowing down. On top of all this, there is the Japan-Korea diplomatic row that has spilled over into trade and security.

- According to the Bank of Korea's advance estimate of South Korea's GDP growth for 3Q2019, the economy expanded 2.0% y-o-y, unchanged from the previous quarter. Growth was mixed across key expenditure components. Notably, gross fixed capital formation growth fell 1.7% y-o-y, its seventh consecutive quarter of contractions. Meanwhile, goods exports contracted for the third consecutive quarter.

- Thus far, the growth pace in the first three quarters of this year came in lower than those in the previous year (Chart 1). With downside risks in the economy outweighing upside ones, South Korea's growth momentum should remain firmly on a downtrend. The latest advance estimate suggests that full-year GDP growth in 2019 will very likely come in lower than the government's forecast range of 2.4% to 2.5%, and even the Bank of Korea's 2.2%.

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



Sources: Bank of Korea, MARC Economic Research

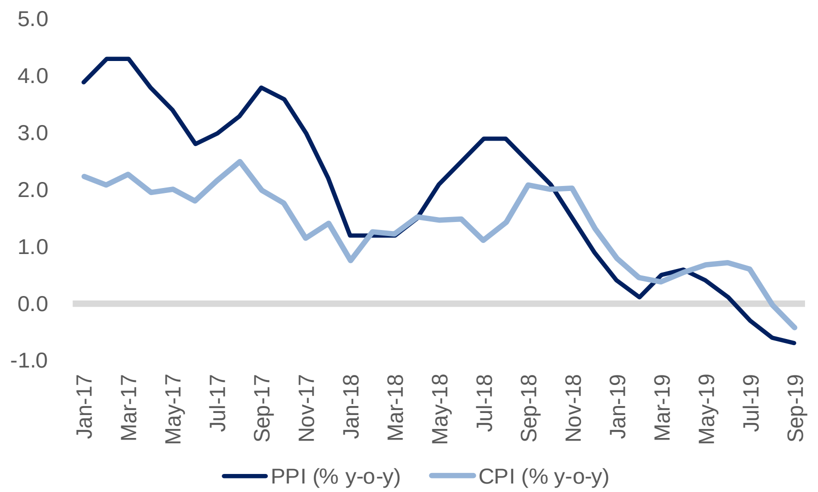
Deflation has become a major concern

- In July, the Bank of Korea cut its policy interest rate, the base rate, by 25 basis points to 1.50%. This was the first cut in three years as the economy continued to lose momentum. This was followed by another 25-basis point cut in October to 1.25%, which matches the record low over the June 2016 – October 2017 period. The first cut had been made to support growth as cooling global demand and spreading trade tensions weighed further on domestic growth. The second cut had been prompted by, besides lethargic domestic growth, deflationary concerns.

- The government projects consumer price inflation in 2019 coming in at 0.9%, which is well below the Bank of Korea's target of 2.0%. In September, South Korea recorded a 0.4% y-o-y fall in the consumer price index, the first time since data releases began in 1965. Underlining deflationary pressure, import prices had fallen for a fourth consecutive month – the longest losing streak since late 2016 – in September.

- Meanwhile, the PPI, a leading indicator of inflation at the consumer level, also fell in September (Chart 2). Marking the third consecutive month of decline, the PPI's y-o-y fall of 0.7% is feeding concerns that this may lead to a prolonged state of weak consumer prices.

Chart 2: Producer price index and consumer price index (% y-o-y)



Sources: Bank of Korea, MARC Economic Research

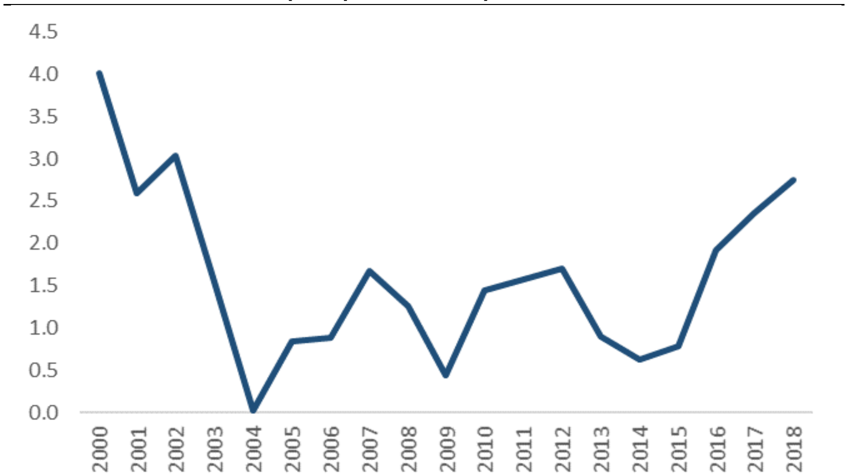
Expect more aggressive government spending to support growth

- South Korea has substantial fiscal space to support growth given that the government is a net creditor. Its debt-to-GDP ratio remains enviably low at below 40%. While the central bank will likely cut interest rates again, it is important to note that the base rate already matches the previous record low. As such, government spending, based on the recent trend (Chart 3), will likely become more aggressive and remain the main support of growth.

- For the 2019 budget, the government allocated 469.6 trillion won (USD419.0 billion), up 9.5% from the previous year. Spending is focused on prodding innovative growth, supporting job-creation projects and strengthening the social safety net. In August, the parliament approved a supplementary budget of 5.83 trillion won (USD4.9 billion). This is aimed primarily at supporting economic growth and efforts to mitigate the impact of Japan's curbs on exports of strategic materials to South Korea. Given rising downside risks, we see the government relegating longer-term restructuring for short-term support.

- For the budget next year, the government has proposed its most aggressive budget spending plan since the Global Financial Crisis. The planned total expenditure of 513.5 trillion won (USD423.5 billion) is up 8.0% (excluding the supplementary budget) from this year. Depending on how the growth situation pans out, a supplementary budget could be forthcoming. However, we feel the government's budget proposal could have been more aggressive from the outset because it has adequate fiscal space.

Chart 3: Structural balance (% of potential GDP)



Sources: International Monetary Fund (IMF)

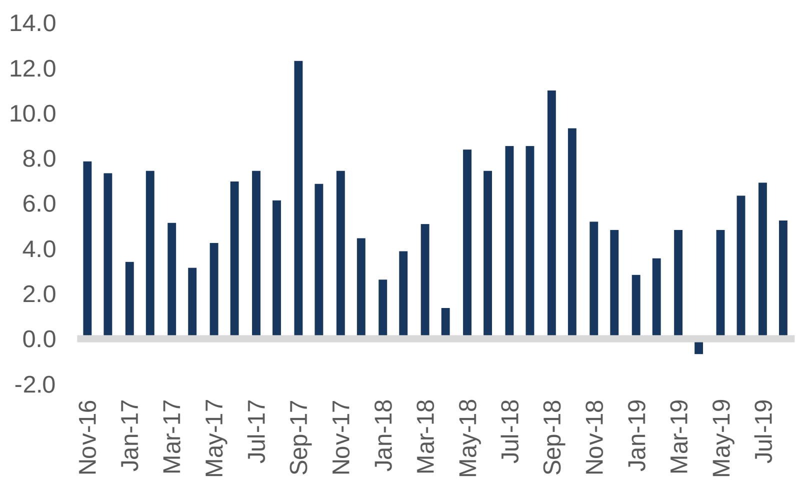
External balance remains robust

- South Korea's external balance sheet remains robust. However, its surplus CA balance remains on a falling, albeit very gradual, overall trend (Chart 4) because of the difficult trade environment and geopolitical concerns. The latest available data show the CA surplus coming in at USD5.3 billion in August.

- In April, the CA balance had fallen briefly into a deficit amounting to USD664.8 million, the first in seven years. This was largely attributed to the primary income balance, which fell 23% y-o-y to a deficit of USD4.3 billion. While April typically sees deficits in the primary income balance due to dividend payouts by corporations settling their accounts from the previous December, it did not help that the trade balance – which had remained in surplus – fell 41.1% y-o-y. For full year 2019, the government expects the CA balance to come in at USD60.5 billion, down from USD76.4 billion in 2018.

- If not for weak domestic demand and private investment, there could have been more pressure on South Korea's external performance. Going forward, we see pressure on its CA balance building up from, besides higher government spending to support the economy, a rapidly ageing population. In any case, South Korea has substantial external buffers. For example, its foreign exchange reserves, standing at USD403.3 billion as of end-September, are ranked among the top-ten largest in the world.

Chart 4: Current account balance (USD billion)



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