Republic of Korea

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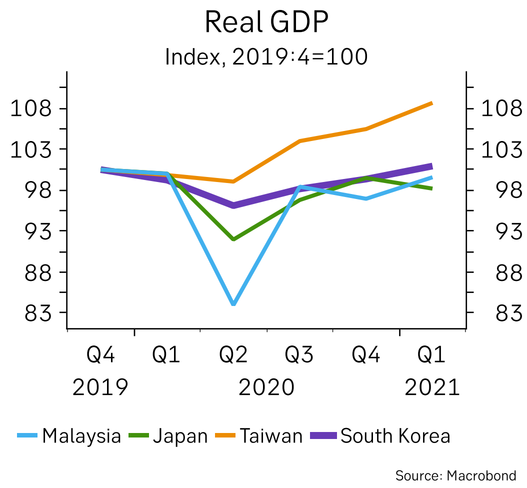
Country Risk Analysis

Recent economic developments

Economic activity continued to slow. Following the slowest pace of growth in a decade in 2019, real GDP contracted 1% in 2020. Compared to most countries in the region, this was a very mild downturn. Most observers attribute this to the authorities' handling of the coronavirus. While most parts of the economy got affected, investment activity held up well, particularly investments in high tech industries such as the semiconductor and display industries. A recovery started taking hold in the last quarter of 2020 and following a surprisingly strong first quarter of 2021 the level of GDP is now back to pre-pandemic levels. However, there still is some way to go before GDP is back to where it was forecasted to be before the pandemic.

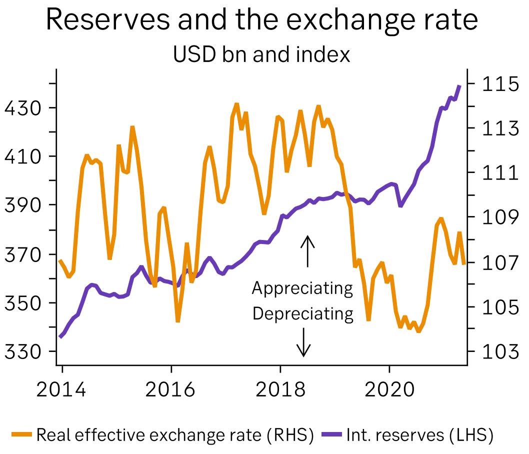


Inflation broadly stable while labour market conditions worsened. Despite the economic slack, inflation was broadly stable last year mainly driven by rising food prices. In 2021, price increases have accelerated and recently reached above the central bank's 2% target. Cooling activity led to some worsening of labour market conditions. Unemployment hit long-term highs of 5.4% in early 2021 but have since decreased.

External metrics strengthened somewhat. A track record of high surpluses on both the trade and current account makes up one of the economy's key credit strengths. In 2020, strong tech exports helped lift the current account further into positive territory, to 4.6% of GDP (3.6% in 2019). Meanwhile, net foreign direct investments rose substantially, contrary to the global trend. The current account surplus has contributed to a rise in foreign reserves which recently reached about USD 452 bn. This is more than twice the size of external short-term debt and equivalent to roughly

10 months of imports, a satisfactory level given the country's floating exchange rate. Reflecting resilient capital flows, the exchange rate appreciated, both in nominal and real effective terms.

External debt rose from low levels. The flexible exchange rate and deep capital markets reduce external vulnerability. Over the past year the comparably low external debt edged up to about 33% of GDP.



Source: Bank of Korea (BOK), J.P. Morgan

Economic policies

Fiscal policy turned expansionary. Following years of prudent fiscal policy, Korea had ample room compared to many other industrial countries to boost fiscal support to milden the downturn. Four supplemental budgets last year resulted in the general government budget balance shifting to a deficit of 3.7% of GDP (incl. social security funds). This shift was milder than average among peers, causing observers such as the IMF to advocate that the authorities maintain a lose fiscal stance for some time.

Deficit caused higher government debt. Government debt as a share of GDP had been edging up already before the corona crisis. The widening of the deficit last year took government debt from about 42% to 48.7% of GDP. As mentioned, deep domestic capital markets have helped keep the foreign currency denominated share of debt low. Debt affordability remains strong although relatively high domestic interest rates have led to an increase in interest rate costs/government revenues. Although explicit government guarantees for the indebted state-owned enterprises (SOEs) are low, a high likelihood of government support means that contingent liabilities are relatively high.

Economic and institutional structures

Resilient economic structures and governance in line with peers. The economy is large and diversified which increases its resilience against shocks. Institutions are considered strong and well in line with most advanced economies. The authorities' relative success in handling the corona crisis could be seen as a reflection of this and of strong government effectiveness. Most World Bank governance related indicators are broadly at par with peers following improvements in the past five years. Korea has improved its rankings in Transparency International's corruption surveys over the past few years but still lags many peers. On the other hand, the country has an attractive business climate reflected in its fifth place in the World Bank's Doing Business rankings.

Financial sector

Large banking sector generally resilient to the downturn. The banking sector is large with total assets amounting to more than 200% of GDP. Aggregate vulnerability indicators reflect a sector that remained sound and well capitalised through-out most of last year. Asset quality is good on average, with non-performing loans making up less than one half percent of total loans.

High household debt on the rise. Despite further tightening of macroprudential policies, households have continued to take on debt. Given also that denominators such as GDP and household incomes declined last year, debt ratios rose significantly. For example, debt as a share of disposable income rose to 171% in Q3 2020. This is higher than in most countries in a similar country risk class, and higher than in most advanced economies. Although subject to debate, high indebtedness mainly poses risks to economic growth in case higher interest rates dents households' ability to consume. It may also limit monetary policy flexibility. The most important mitigating factors are that households' financial assets have risen more than debt over the past year and that loan to value ratios remain relatively low.

Political and security developments

Less popular President Moon Jae-in keeps focus on the North in his final year. The DPK's clear victory in the 2020 parliamentary election has enabled it to pass legislation more easily over the past year. Meanwhile, President Moon Jae-in's who is in his final fifth year as President is losing in approval ratings. Some observers conclude that his focus on improving relations with North Korea, where little progress has been made, is not what the average voter is prioritising. Presidential elections are due in March 2022. The prospects for meaningful progress until then are considered meagre.

North Korea stalemate. The detente that began in early 2018 soon stalled and has partly reversed. Missile testing has resumed and North Korea's rhetoric towards South Korea and the US has become increasingly aggressive. Similar to experiences in the past decades, tensions have not materially affected economic activity.

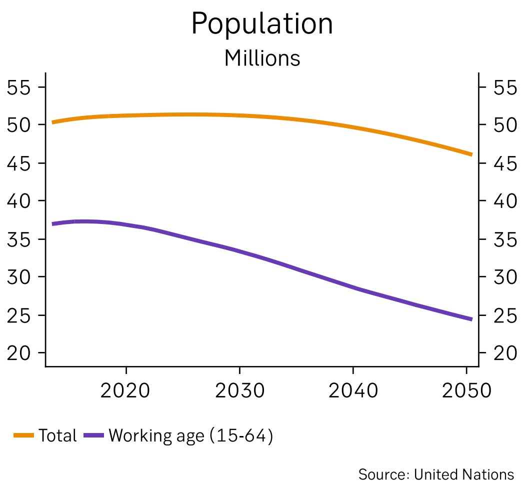
Outlook

Steady recovery is on track. Our house forecasters, Oxford Economics, recently upped their forecast for real GDP growth in 2021 to 4.5% based on a surprisingly strong recovery in the first quarter of the year. Exports will be boosted by the ongoing recovery in global trade, in particular by the strong demand for semiconductors and automobiles. The central bank is slightly less positive expecting growth at 4% this year. Uncertainty relating to the coronavirus developments (containment and vaccination roll-out) means the forecast is subject to a high degree of uncertainty.

Fiscal policies to remain expansionary. The government plans for budget deficits to remain relatively high up until at least 2023 and hence expects that debt will continue to rise towards historically high 60% of GDP. Sustained spending increases are in line with the government's income-led growth strategy and investments under the Korean New Deal (KND, see below). The maintained stimulus will add to fiscal pressures stemming from the aging population. In light of this, the government recently proposed a new set of fiscal rules, including a gross debt anchor at 60% of GDP. The stimulus plans have so far not alarmed analysts nor financial market participants, despite the added uncertainty posed by the 2022 elections.

Medium-term prospects remains broadly unchanged. Oxford Economics projections indicate relatively moderate medium-term damages to the economy from the current downturn. Some other analysts, however, are concerned over a secular decline in growth. The government, in an attempt to stimulate new growth drivers in the post-covid environment, launched the Korean New Deal (KND) last year. It envisages public spending in the order of 5.9% of GDP together with private investment, targeting projects that make economic activity greener and lead to increased inclusiveness. The initiative spans the period 2020-2025. In addition, it appears likely that the digitalization of the world economy could continue to benefit the export sector also in the medium-term. On balance, economic growth is likely to be somewhat higher than in most higher-income countries. This should facilitate a consolidation of government finances when the authorities decide to do so.

Aging population is a challenge and country risk weakness. A key longer-term challenge remains the rapidly aging population. Although average economic growth has been high relative to many peers, most estimates indicate a declining potential growth rate over the past decades. This is partly related to the diminishing contribution from the size of the workforce. Although the total population is projected to grow for a few more years, the working age population peaked in 2016. United Nation's projections indicate that its share of the total population will drop to 50% by 2060, similar to Japan. To compensate for this the government has been stepping up efforts to raise productivity growth. It is already a leading economy in the adoption of ICT and in innovation capability, and the KND is yet another effort in the area. The aging population risks weighing not just on growth, but also on government finances and therefore is a key country risk negative.



Contingent liabilities from the North are the most important risk. We assume that the geopolitical risks stemming from the North will not materialise and reach a point where they impact South Korea's key credit fundamentals. However, external security continues to present the most important country risk weakness and tail-risk event. A low probability event involving a collapse of North Korea or a significant military escalation would put immediate and sustained pressure on Korea's finances.

KOREA: KEY ECONOMIC INDICATORS

Macroeconomic	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**
GDP (USD bn)	1500	1623	1725	1647	1631	1837	1990	2119
GDP/capita (USD)	31769	33722	32148	31806	35807	38754	41267	43573
GDP (change)	3,2%	2,9%	2,0%	-0,9%	4,5%	3,4%	2,8%	2,3%
Investments/GDP	32%	30%	29%	30%	30%	30%	30%	31%
Government finances								
Budget balance/GDP	1,3%	1,6%	-0,6%	-4,2%	-3,6%	-3,9%	-3,9%	-3,7%
Excluding soc. security funds	-0,6%	-2,8%	-2,0%	-4,2%	-	-	-	-
Govt debt/GDP	36,7%	39,6%	42,2%	48,7%	53,2%	57,2%	61,0%	64,3%
Money and prices								
CPI inflation	1,9%	1,5%	0,4%	0,5%	1,7%	1,6%	1,9%	1,9%
Money demand (change yoy)	5%	7%	8%	10%	8%	5%	5%	4%
Stock prices, index	872	855	833	833	823	822	824	825
Interest rates	1,4%	1,7%	1,7%	0,9%	0,8%	0,9%	1,2%	1,5%
Exchange rate (USD)	1131	1100	1165	1180	1113	1086	1075	1066
Trade/GDP	75%	74%	68%	68%	79%	73%	71%	69%
Oil price (Brent)	$54	$71	$64	$42	$67	$60	$60	$61
Balance of payments (USD, bn)								
Export of goods	661	687	699	682	757	784	807	830
Imports of goods	467	516	477	435	527	566	600	634
Current account	75,2	77,5	59,7	75,3	86,1	72,1	83,1	93,0
as % of GDP	5,0	4,8	3,5	4,6	5,3	3,9	4,2	4,4
FDI (net)	-16	-26	-26	-23	-24	-25	-26	-28
Loan repayments	-75	-81	-87	-98	-108	-112	-115	-117
Net other capital flows	34	43	58	78	65	89	85	80
Change in reserves	18	14	5	32	19	25	27	29
Debt and liquidity (USD, bn)								
Reserves	379	393	398	430	449	474	501	530
in months' of imports	10	9	10	11	10	10	10	10
External debt	412	441	471	545	563	577	587	593
o/w short term debt	116	126	134	157	163	167	170	171

Source: Oxford Economics, IMF

Rating history (eoy)				
Fitch	AA-	AA-	AA-	AA-
Moodys	Aa3	Aa2	Aa2	Aa2

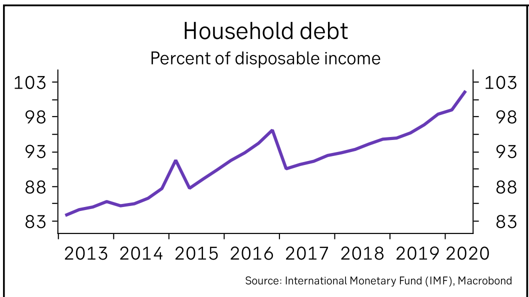
Type of government:

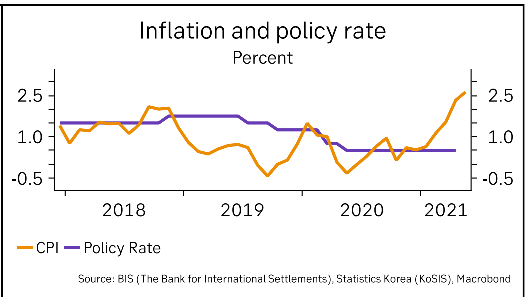
Next elections — Presidential: 2022 — Legislative: 2024

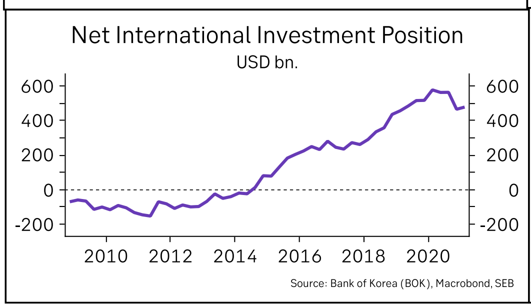
Other:

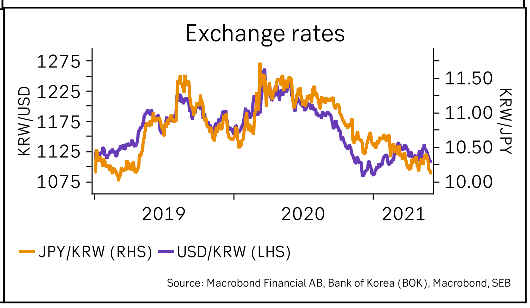
Latest PC deal — None

Latest IMF arrangements — Stand-by 1997









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