Republic of Korea

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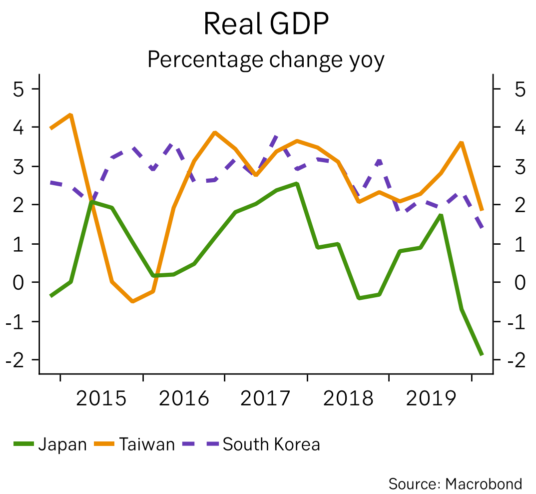
After decelerating to its slowest pace in a decade last year, GDP growth will fall sharply in 2020. External balances remain a key country risk strength despite the current collapse in foreign demand. Years' of government budget surpluses have provided ample room for fiscal stimulus to milden the downturn. An expected rise in government debt over the next two years should still leave it at moderate levels. The rapprochement with North Korea has been halted and in some areas reversed. Hence, external security continues to present the most important credit weakness and tail-risk event.

Country Risk Analysis

Recent economic developments

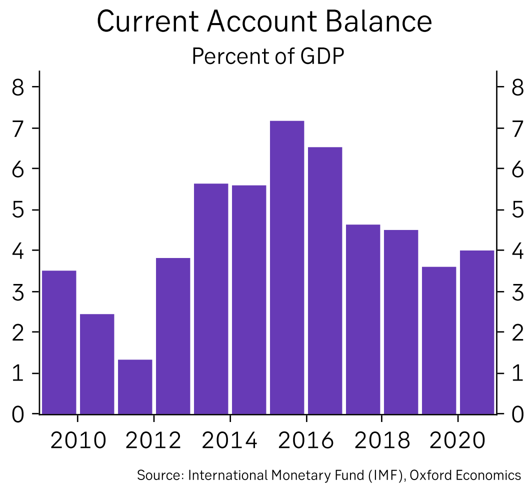
Slowdown in 2019 continues in 2020. Growth slowed to 2% in 2019, its slowest pace in a decade, as both external and internal headwinds intensified. With the corona crisis hitting the economy in early 2020, first quarter GDP growth slowed further. Although second quarter GDP data is expected to be even worse, there are signs, including improving household sentiment and labour market data, that the economy may be bottoming-out. Historically, swings in GDP growth rates in Korea has been low compared to other similarly rated economies, showing the economy's resilience despite its openness.

Inflation declining and labour market conditions worsening. Inflation has been trending downwards since 2017. As economic activity and oil prices have plunged, headline inflation recently slowed markedly to -0.4%. Meanwhile, labour market conditions have worsened.



External accounts remain strong despite collapse in foreign demand. A solid track record of high surpluses on both the trade and current account makes up one of the economy's key credit strengths. This being said, export growth was lacklustre in 2019 following increasingly dismal global trade conditions in general and the cyclical downturn in the global electronics sector in particular. With global demand collapsing in the past few months, exports have plunged. In May, they fell nearly

24% yoy. The resulting decrease in the current account surplus last year could be followed by a slightly higher surplus again in 2020 as the external environment improves in the latter part of the year. The current account will continue to be supported by the country's aging population which raises the propensity to save. Meanwhile, Korea's net international investment position has been positive since 2015 and continued to rise in 2019, further reducing one of the economy's past vulnerabilities.



Low external debt and high reserves. Deep capital markets and a flexible exchange rate are other factors that reduce external vulnerability. This has helped keep external debt at low levels compared to country risk peers. Finally on the external side, the current account surplus contributed to a small rise in foreign reserves last year. This increase was partly reversed over the past months, most likely due to central bank interventions to stabilise the exchange rate. FX reserves at about USD 396 bn are equivalent to about 10 months' of imports. This should be satisfactory given the country's floating exchange rate.

Economic policies

Fiscal policy responding to the downturn. Following years of prudent fiscal policy, Korea has ample room for fiscal manoeuvre relative to many other industrial countries. With the government having adopted three supplemental budgets this year to milden the downturn, the general government deficit is expected to reach 4.5% of GDP.

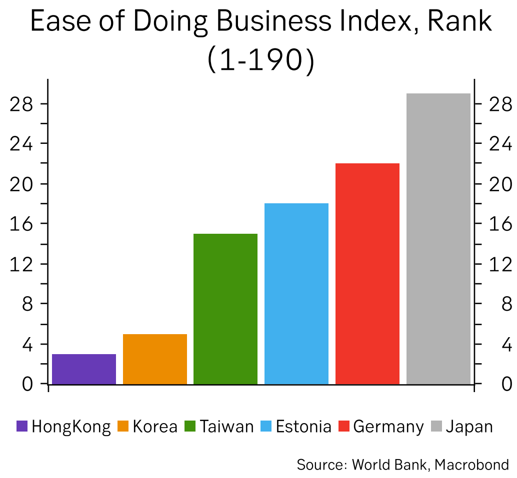
Government debt to rise from moderate levels. Despite budget surpluses being the norm over the past decade, debt as a share of GDP has edged up in the past few years. At about 40% of GDP last year it is broadly at par with country risk peers. Domestic capital markets are deep which have helped the authorities to keep the foreign currency denominated share of debt low. Higher deficits in the near-term has led the IMF to forecast that debt/GDP will reach close to 50% in 2021.

Contingent liabilities are not negligible. Explicit government guarantees for the indebted state-owned enterprises (SOE) are low. Nevertheless, it is highly likely that the government would support the larger companies. According to Standard & Poor's, the combined debt of the SOE:s equalled roughly 28% of GDP by the end of 2018. Hence, contingent liabilities are assessed to be relatively high.

Monetary policy easing starting in 2019 has been accelerated in 2020. The central bank (BOK) enjoys a high degree of independence and has built relatively solid credibility for its inflation targeting regime in place since the Asian financial crisis. As the economy weakened last year and inflation was low, the central bank started to cut interest rates. Three additional cuts in 2020 have brought the policy rate to 0.5%. Meanwhile, the BOK has taken a wide set of measures to help small companies and improve liquidity. Expectations are building that the BOK will formally launch a programme of quantitative easing.

Economic and institutional structures

Resilient economic structures reduces country risk. The economy is large and diversified, increasing its resilience against shocks. Institutions are considered strong and well in line with most advanced economies. This may have been one explanation to the authorities' success, so far, in responding to the coronavirus outbreak.



Corruption related scandals in the past have served as a reminder, however, of the close and sometimes murky relationship between the government and the large chaebols. This is reflected in surveys by the World Bank and Transparency International and weighs on the overall quality of governance. On the other hand, Korea boasts an attractive business climate reflected in its fifth place in the World Bank's Doing Business rankings. GDP per capita is slightly lower than average for countries at a similar level of country risk but is rising faster than most peers.

Financial sector

Large banking sector is broadly sound. The banking sector is large with total assets amounting to more than 200% of GDP. Aggregate vulnerability indicators reflect a largely sound and well capitalised sector. Asset quality is good on average, with non-performing loans making up less than one percent of total loans.

High household debt continued up. Although the tightening of macro prudential regulations has slowed the growth in household lending, it continues to rise. Last year, debt as a share of GDP edged up to roughly 97% of GDP. This is higher than in most countries in a similar country risk class, and higher than in most advanced economies. Concerns over the threat that this poses to financial stability is probably overstated. Instead, high indebtedness mainly poses risks to economic growth, in the case that higher interest rates dents households' ability to consume. A mitigating factor is that households' financial assets are equivalent to more than twice the size of their debt.

Political and security developments

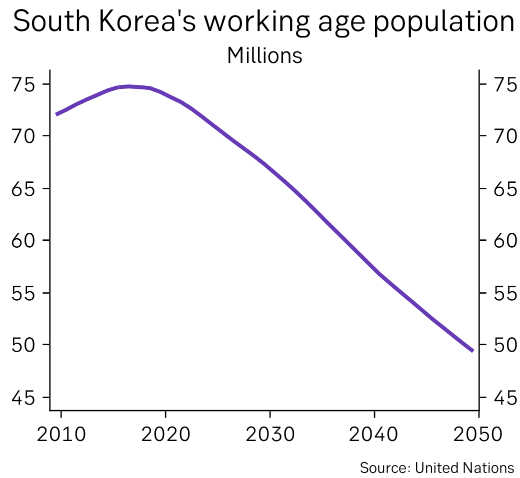
Incumbents won general elections. As expected**,** President Moon Jae-in's centre left Democratic Party of Korea won the April general elections. However, the landslide victory, with the party together with its sister party taking 180 of parliament's 300 seats, surprised most analysts. The win was likely helped by strong approval of the government's handling of the corona crisis. Having avoided becoming a lame-duck, the President will now be able to govern more efficiently. Policy wise the focus in the near-term will remain on handling the corona crisis. As to foreign relations, political tensions with Japan have risen following the dispute over wartime issues in mid-2019, spilling over to trade. Analysts expect that the strong election result will strengthen Moon in his hard line against Japan and his conciliatory approach towards North Korea.

North Korea relations have deteriorated. After years of heightened security tensions on the Korean peninsula, tensions decreased during 2018 as diplomatic talks resumed. Over the past year, however, the rapprochement with North Korea has stalled, and in some areas reversed. For example, no progress has been made on de-nuclearization. Instead, weapons testing has resumed, and North Korea's rhetoric has become aggressive. Recently, direct bilateral communication channels were cut off.

Outlook

Historically deep economic contraction, although milder than peers. Our house forecasters, Oxford Economics, expect real GDP to contract by 0.7% in 2020 before rebounding by 3.2% in 2021. The contraction this year would be the first year of declining GDP since the Asian financial crisis. Compared to other countries in the region, it is still a modest downturn. The central bank has a similar forecast projecting growth to be roughly flat this year. Given Korea's heavily export-oriented structure, the recovery much depends on the recovery of the global economy and trade.

Smaller than expected economy in the medium-term. Oxford Economics projections indicate relatively moderate medium-term damages to the economy from the current downturn. They forecast that the size of the economy (nominal GDP) by end-2022 will be 7% smaller than they expected one year ago. This is broadly in line with average among OECD economies.



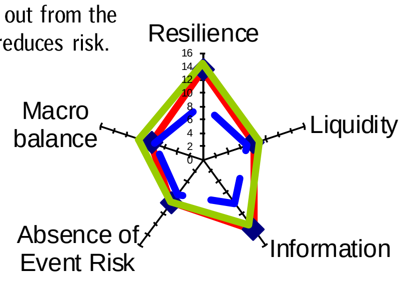
Aging population is a key country risk weakness. Looking further ahead, the economy faces some of its key challenges from a rapidly aging population. The working age population peaked in 2016 and United Nation's projections indicate that its share of the total population will drop to 50% by 2060. The Korean Development Institute projects potential GDP growth to gradually fall towards about 1.1% by 2060 as fewer and fewer labour are put into the production. The aging population will weigh 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 escalate 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. Another external risk relates to the trade tensions with Japan intensifying. Various trade sanctions introduced in 2019 only appears to have made a marginal impact on trade.

Korea: Risk Profile

Key ratios	2020
Population (mn.)	51,2
GDP/capita (USD)	31395
GDP (% change)	-0,7%
Inflation	0,2%
Current Account Balance/GDP	4,0%
Reserves/imports (months)	10
Budget balance/GDP	-4,5%
Government debt/GDP	46%

How to read the chart?
Moving out from the center reduces risk.



External ratings:
Fitch: AA-
S&P: AA
Moody's: Aa2

Peers:
Japan
Chile
Taiwan

Graph: Korea's risk profile is stronger on resilience and liquidity than the average for all emerging market countries. However it is weighed down by event risk, much like its peer Taiwan.

KOREA: KEY ECONOMIC INDICATORS

Key data:	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**
GDP (USD bn)	1415	1530	1726	1647	1610	1757	1862	2003
GDP/capita (USD)	27856	31780	33732	32158	31395	34244	36266	39013
GDP (change)	2,9%	3,1%	2,9%	-0,6%	-0,7%	3,2%	2,8%	2,7%
Investments/GDP	30%	32%	30%	30%	30%	30%	31%	30%
Government finances								
Budget balance/GDP	1,0%	1,4%	1,6%	-0,6%	-4,5%	-0,4%	0,0%	0,2%
Govt debt/GDP	37,6%	36,7%	37,9%	40,7%	46,2%	49,2%	49,0%	49,0%
Money and prices								
CPI inflation	1,0%	1,9%	1,5%	0,4%	0,2%	1,2%	1,9%	2,0%
Interest rates	1,4%	1,4%	1,7%	1,7%	0,9%	0,7%	1,1%	1,6%
Exchange rate (USD)	1161	1131	1100	1165	1216	1179	1156	1127
Trade/GDP	74%	76%	79%	77%	69%	72%	74%	77%
Oil price (Brent)	$44	$54	$71	$64	$38	$44	$49	$53
Balance of payments (USD, bn)								
Export of goods and services	594	653	720	658	587	672	726	791
Imports of goods and services	456	517	643	610	521	588	654	715
Current account	99	78	77	60	64	80	68	73
as % of GDP	7,0	5,1	4,4	3,6	4,0	4,6	3,6	3,6
FDI (net)	-18	-15	-26	-25	-26	-29	-30	-31
Debt service	76	81	89	97	102	102	103	108
External debt and liquidity (USD, bn)								
Reserves	363	373	393	398	401	424	448	474
in months of imports	9	10	9	10	11	11	10	10
Total external debt	392	411	441	467	473	484	499	516
o/w short term	105	117	126	134	145	148	153	158

Source: Oxford Economics, IMF

Rating history (eoy)				
Fitch	A+	AA-	AA-	AA-
Moodys	A1	Aa3	Aa2	Aa2

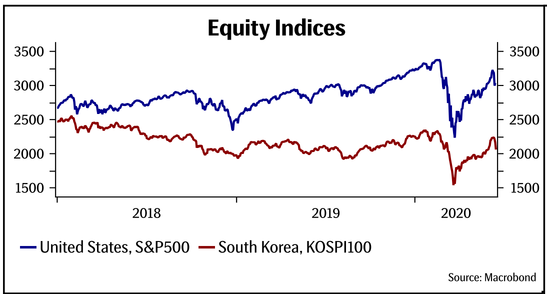
Type of government:

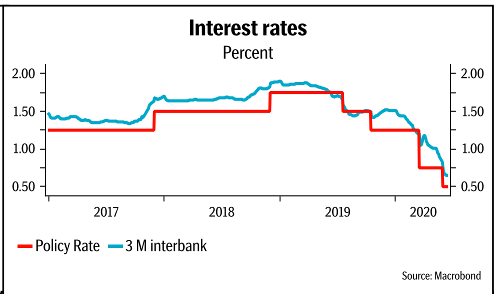
Next elections — Presidential: 2022 — Legislative: 2024

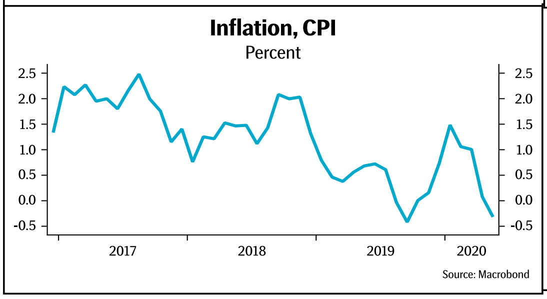
Other:

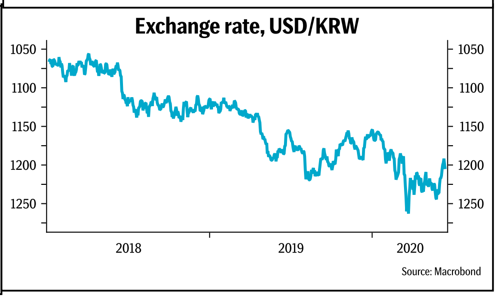
Latest PC deal — None

Latest IMF arrangements — Stand-by 1997









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