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Economic Watch

Asia

Hong Kong, December 19, 2011
Economic Analysis

Asia

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Lessons of 2008-09 leave South Korea better prepared

With the world's attention focused on the Korean peninsula following the announcement today of the death of North Korea's leader, Kim Jong-Il, it is all the more timely now to assess South's Korea's economic prospects. The report below is based on a recent visit to Seoul, in which we met with policymakers and researchers. We find that Korea's economic resilience has strengthened in recent years, and this should help contain risks from a worsening external environment, and also limit the economic fallout of the latest news from North Korea.

Summary

- Korea's economic resilience has been strengthened over the past few years. This is due to a series of macro-prudential measures in response to the 2008-09 global financial crisis, which had an especially severe impact on Korea due its export dependence and reliance on short-term external borrowing. Since then, the current account has been in surplus, short-term debt has fallen, reserves have increased, and key banking sector indicators have improved. Korea's public finances are also sound, providing a policy buffer in the event of a sharp weakening in external demand.

- Korea enjoys an investment-grade rating by major agencies, and in November Fitch raised its outlook to positive from stable despite the worsening external environment.

- While exports have been slowing due to weak demand from the US and Europe, some of the slack has been taken up by emerging market economies and by robust domestic demand. We project full-year GDP growth of 3.7% in 2011; our previous projection for 2012 of 3.8%, however, is at risk given a worse external outlook.

- Well before the latest news from North Korea, the predominant concern among investors and policymakers has been about risks from the deepening European debt crisis. Aware of the economy's vulnerability to external shocks, the Bank of Korea (BOK) has been preparing contingency plans to deal with the worsening external crisis. Korea has also announced new swap arrangements with Japan (US$70 billion), and China (RMB 360 billion), which can be activated to boost already substantial reserve levels.

- In addition to risks of portfolio outflows, the main vulnerabilities on the economic front stem from the high levels of private short-term external and household debt. The former has been declining, although it is still high and could lead to dollar funding issues. Meanwhile, the latter is still increasing, but with low delinquency rates household debt is more of a potential drag on growth than a threat to financial stability.

- As elsewhere, the priority for monetary policy has shifted in recent months from fighting inflation to supporting growth. The BOK has kept its policy rate at 3.25% for the past six months, and we believe they will remain on hold, with interest rate cuts likely only if the growth outlook deteriorates sharply.

- Tensions with North Korea are again in the spotlight following the unexpected announcement of the death of Kim Jong-Il, North Korea's leader. While his death greatly increases the degree of uncertainty, the outlook for relations with the North has probably not changed appreciably, as Kim's health was known to have been deteriorating, and a succession process was already in place to his son, Kim Jong-un.

Economic developments and outlook

- Korea rebounded strongly after the 2008-09 global financial crisis, with GDP growth of 6.2% in 2010 (Table 1). The economy has recently slowed, however, with sequential growth declining in the second and third quarters of 2011 to 0.9% and 0.7% (seasonally adjusted, non-annualized), and we expect overall growth for the year to reach 3.7%. Exports were the main contributor to growth through the third quarter, led by electronics and steel. One of the reasons for the strong export growth in the face of weakening demand from the US and Europe, has been a diversification of export markets toward emerging economies, which now take up 70% of Korea's exports (China is Korea's largest export market, taking about 25% of the total). Korean products' strong brand recognition and competitive advantage from a weak won are additional factors in their favor.

Table 1
Korea economic outlook (Baseline scenario)

	2007	2008	2009	2010	2011F	2012F
Real GDP growth (YoY%)	5.1	2.3	0.3	6.2	3.7	3.8
Private consumption (YoY%)	5.1	1.3	0.0	4.1	2.7	2.9
Investment (YoY%)	4.2	-1.9	-1.0	7.0	0.7	5.0
Inflation (YoY%, avg)	2.5	4.7	2.8	3.0	4.4	3.4
Foreign exchange rate (KRW/USD, eop)	931	1362	1163	1145	1080	988
Policy rate (%, eop)	5.0	3.0	2.0	2.5	3.3	3.5
Fiscal deficit (% of GDP)	3.4	1.3	-1.9	1.3	0.7	0.8
Current account (% of GDP)	2.0	0.5	3.9	2.7	1.5	1.5

Source: BBVA Research

- Inflation temporarily rebounded in November (to 4.2% y/y, from 3.6% y/y in October), as we had expected, but is forecast to fall within policymakers' target range of 2-4%. Inflation appears to have peaked in the summer (5.3% y/y in August), and we expect the downward trend to continue, especially after the CPI basket was updated in November, which alone is expected to lead to a 0.4% y/y decline in measured inflation..

- After a series of five hikes beginning in July 2010 that brought the policy rate to 3.25% from a record low of 2.00% (Figure 1), the Bank of Korea (BOK) has been on hold since June. That stance is likely to continue in the near future, as rate hikes are off the table due to the weakening external environment and declining trend in inflation. At the same time, there is a reluctance to cut rates at this stage, given that real interest rates remain negative, and due to concern about fueling further household borrowing (the BOK views 4.00% as a neutral policy rate). Rate cuts are expected only in the event of a further significant deterioration in the external environment.

- Despite persistent current account surpluses and prudent fiscal management (debt-to-GDP of 35%), currency appreciation has lagged behind regional peers, giving Korean exporters a competitive edge. Capital outflows explain some of the weakness, perhaps due to concerns about tensions with North Korea, as seen by the immediate reaction in financial markets to the announcement of Kim Jong Il's death. To reduce such currency volatility over the past year the authorities have introduced additional macro-prudential measures such as a 14% withholding tax on foreign investors in government bonds in January 2011 (the measure was introduced in response to capital inflows, but is largely symbolic given tax treaties with the majority of investor countries).

- Korea has enjoyed investment-grade ratings by the major agencies since 1999 in recognition of its healthy public finances, long-term growth prospects, and low debt levels. Moody's maintains a sovereign rating of A1, and Fitch and S&P have ratings of A+ and A, respectively. In November, Fitch upgraded its outlook to "positive" from "stable," citing increasing foreign reserves and decreasing short-term debt, despite the weakening external environment.

- Foreign reserves peaked at US$312.2 billion in August 2011 and stand at US$308.6 billion as of November, up from a low of $200 billion during the depths of the 2008-09 global financial crisis. As such, reserve coverage to short-term debt stands at well over 100%. To further bolster its reserve position, in October the Bank of Korea negotiated new bilateral swap agreements with the Bank of Japan (US$70 billion) and with the People's Bank of China (RMB 360 billion, although given its denomination in a non-convertible currency, it would be less useful than the swap line with Japan in the event of an external shock). That said, given the uncertain external outlook, external investors often express concern over possible shortages in onshore dollar liquidity. According to the Bank of Korea, there have been as of yet no signs of such shortages, and to date external creditors have largely maintained their credit lines, with some small deleveraging from European banks.

- That said, the growth outlook for 2012 is subject to a high degree of uncertainty due to the external environment, with risks to the downside. Several forward-looking indicators have been trending down, such as consumer confidence, business confidence, and PMI. The latest news from North Korea heightens these downside risks.

- The government's original growth projection for 2012 (set in July) was 4.5%, but this is likely to be revised downward. The BOK has just lowered its growth outlook for 2012 to 3.7%, and even that may prove optimistic in light of increasing downside risks. Inflation appears to have peaked, and will likely fall further to 3.4% in 2012, within the official 2-4% inflation target. Monetary policy would likely remain on hold under this baseline for most of 2012. Given their traditional fiscal prudence, the authorities are targeting fiscal balance (excluding social security contributions) by 2013. They are reluctant at this stage to adopt stimulus measures, preferring instead to front-load spending in 2012. The budget is likely to be passed in February, and could contain contingency stimulus measures in the event of a sharp slowdown in growth.

- The outlook for the currency depends heavily on the external environment. The Won is one of the region's "high beta" currencies, fluctuating in line with global risk aversion. A stabilization in the external environment would return the won to a gradual appreciation trend, as in our baseline projection.

- The coming year will be highly politicized, with National Assembly elections to be held in April, followed by Presidential elections in December. The outlook for the ruling GNP party remains uncertain, especially given a populist backlash (symbolized by the election in October of an opposition candidate for Mayor of Seoul). A politicized environment may make passage of stimulus measures more difficult during the course of the year. For this reason, the budget to be passed in February may contain automatic contingency measures to support growth in the event of an economic downturn.

Risks to the outlook

- Despite rising risks to the external outlook, Korea's economy is operating from a stronger position than during the 2008-09 financial crisis. Foreign exchange reserves are at comfortable levels, which would enable the Bank of Korea to provide onshore dollar liquidity if necessary. Moreover, the current account remains in surplus, and external short-term debt has been reduced (US$138.5 billion at end-September, or 35% of total external debt, down from over 50% in recent years). Other macro vulnerabilities that came to the fore during the previous financial crisis have also been reduced, including a lowering of banks' loan-to-deposit ratios under government guidelines to reduce the ratio to below 100% by mid-2012 (high loan-to-deposit ratios were a source of vulnerability during the 2008-09 crisis).

- In the event of a sharper deterioration in the external environment, the BOK would likely cut interest rates, and as noted above there would be ample scope for fiscal stimulus measures, as was the case in 2008-09. With these measures, we would expect growth to be maintained at around 0-2% under a risk scenario (growth declined to +0.3% in 2009).

- A particular source of external risk could come through banks' foreign borrowing in the event of a tightening in credit conditions from abroad. Korea is heavily dependent on European banks for financing. According to BIS data, 48% of external debt is sourced from European banks, within which 32% of total foreign borrowing by Korean banks is from Europe (the latter statistic is provided by the Korean Ministry of Strategy and Finance). Similarly, around 30% of foreign holdings of Korean equities and bonds is from European investors. Therefore, an abrupt pullback in financing from European financial institutions and investors could put pressure on the overall foreign financing picture.

- Household debt levels remain high. In particular, the debt-to-disposable income ratio stands at 146%, above the OECD average of 134%, and the level of household debt has continued to grow, by 5.4% year-to-date in 2011 (after growing by 8.1% in 2010). That said, most of the consumer borrowing is backed by assets, and is extended to high income households which have a high capacity to repay. As a result, delinquency ratios remain low, and the average loan-to-value ratio (48%) of Korean homeowners is much lower than in Western economies (US 75%, UK 85%).

- This past June, the Financial Supervisory Service (FSS) implemented measures to curtail the high level of household debt. The measures include debt-to-income limits on mortgage loans, higher BIS risk weights to high-risk mortgage loans, and leverage regulations on nonbank institutions. The authorities believe these measures have been effective in slowing the rate of credit growth to the household sector. Credit growth to households has decelerated to 8.6% y/y through September after an average growth rate of 10.4% y/y from 2005-2009.

Financial sector outlook

- The soundness of the banking sector has continued to improve following the crisis of 2008-09 which exposed vulnerabilities stemming from banks' reliance on wholesale funding and external borrowing. Short-term external debt has been reduced and, importantly, banks' loan-to-deposit ratios (LTD) have declined from their peaks in 2008 (Figure 2) as banks reduce their reliance on non-deposit source of financing. The authorities believe that banks are well on their way to meeting the required LTD ratio of 100% by mid-2012. Macro-prudential measures to reduce foreign borrowing include a levy on non-core FX liabilities of banks, and lower FX derivatives ceilings.

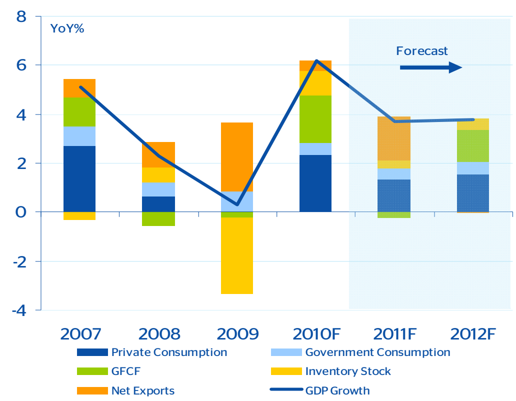
- Mutual savings banks (MSBs) have been facing increasing scrutiny following the closure of seven MSB's earlier this year. The situation has calmed, however, and does not pose systemic risks (the MSBs account for only around 5% of total banking system assets). There are at present over 100 savings banks, and measures have been implemented to improve governance and restructure the sector.

- The banking system is well-prepared for Basel III implementation and has plenty of capital (the BIS ratio is 14.17%, and the Tier 1 ratio is 11.45% as of November). Additionally, the overall household loan delinquency ratio and the mortgage loan delinquency ratio as of September are 0.71% and 0.63%, respectively.

- Overall lending growth remains sluggish at around 2.8% y/y through August, after 3.9% y/y growth in 2010. This is in contrast to a relatively high rate of credit growth in other Asian economies, reflecting a deleveraging process and sluggish credit growth to SMEs in particular. Other credit segments have grown more rapidly, including mortgages and corporate loans.

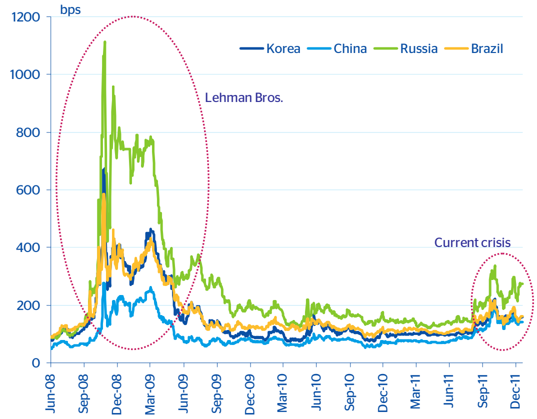
Figure 1: Recent economic developments

GDP growth has moderated after a sharp rebound in 2010



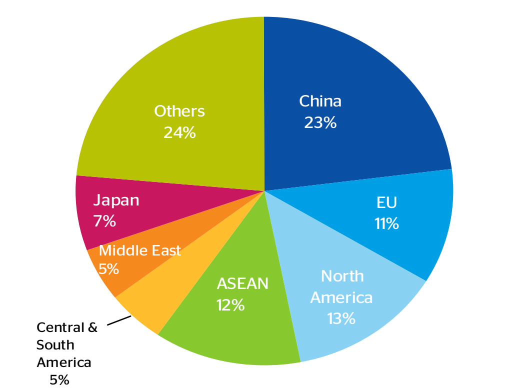
Source: CEIC and BBVA Research

Korea's CDS spread has picked up, but remains well below 2008-9 levels



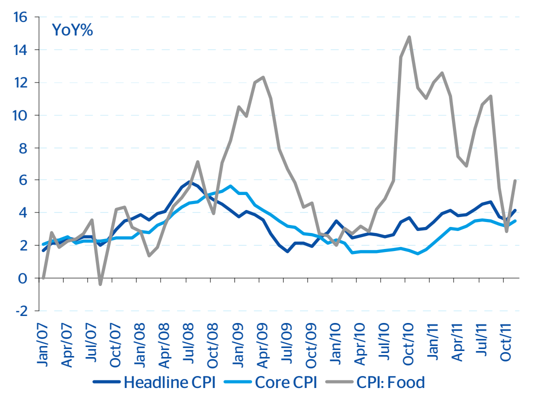
Source: CEIC and BBVA Research

China is Korea's largest export market, but trade with the EU and US still represent a large share



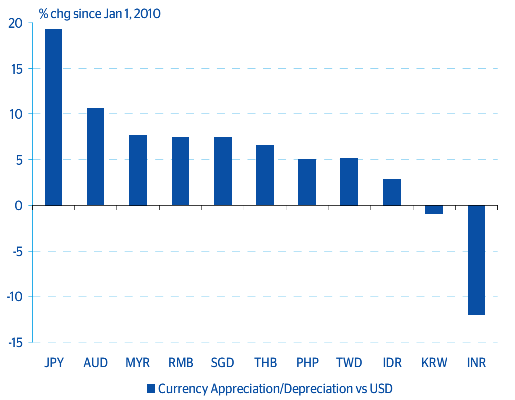
Source: CEIC and BBVA Research

Inflation remains towards the high end of the target range, but is expected to ease



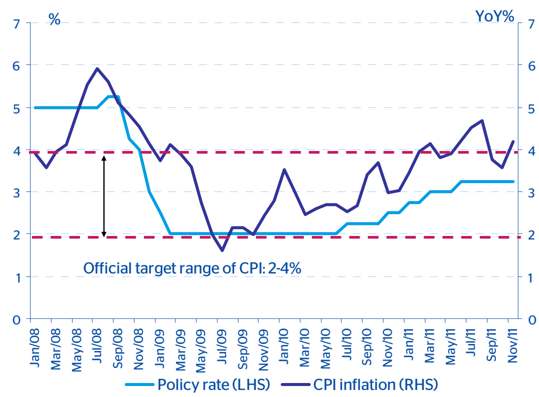
Source: CEIC and BBVA Research

The Won's appreciation since early 2010 has lagged



Source: CEIC and BBVA Research

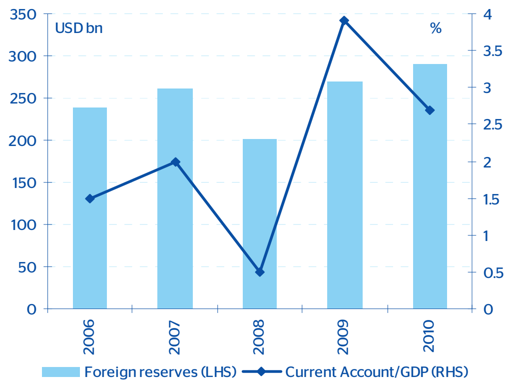
Interest rates are negative in real terms



Source: CEIC and BBVA Research

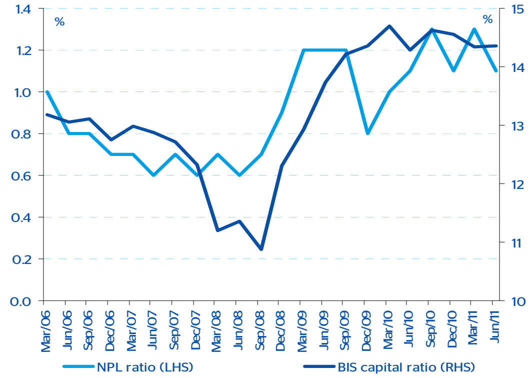
Figure 2: Exchange rates, reserves, and financial sector

Foreign reserves have increased and the current account is in surplus



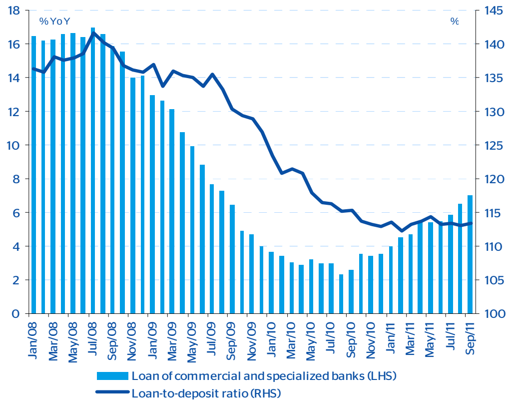
Source: CEIC and BBVA Research

Capital adequacy ratios are high, and NPLs are low



Source: CEIC and BBVA Research

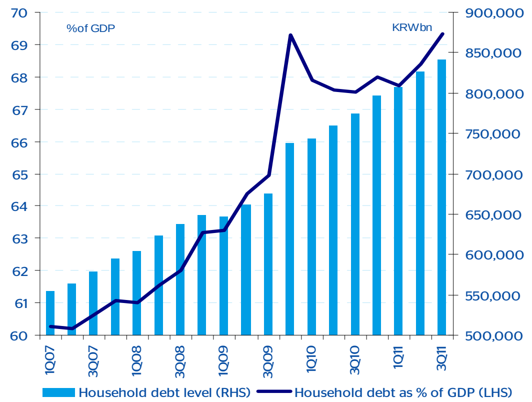
Credit growth has picked up, and loan-to-deposit rates are falling...



Source: CEIC and BBVA Research

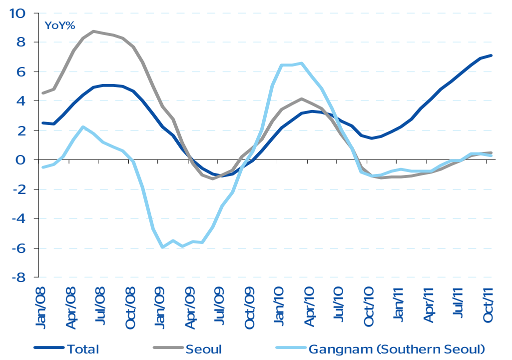
* The loan-to-deposit ratio is calculated as the total loans and deposits of commercial and specialized banks

...but increasing household debt remains an issue



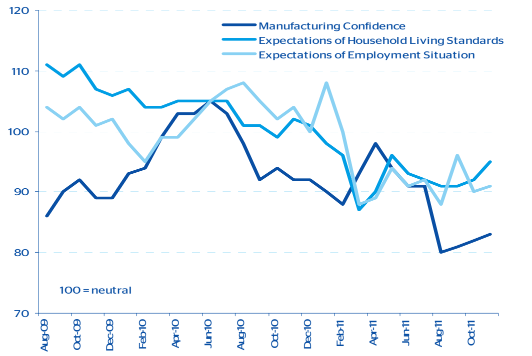
Source: CEIC and BBVA Research

Housing prices overall are increasing nationwide, but are steady in Seoul



Source: CEIC and BBVA Research

Leading indicators show signs of pessimism



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