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Economic Watch

Asia

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Economic Analysis

Asia
Chief Economist for Asia
Stephen Schwartz
stephen.schwartz@bbva.com.hk

Economist
Jenny Zheng
jenny.zheng@bbva.com.hk

Korea's robust outlook

Inflation is the main challenge, as growth stays strong and financial soundness improves

- **The Korean economy has rebounded strongly from the 2008-09 global financial crisis**
  GDP growth rose to 6.1% in 2010 on strong exports and domestic demand. A proactive policy response and a recovery in global demand were key factors. Growth in 2011 is projected to moderate to a still-strong 4½-5% on improving global demand and further gains in private consumption and investment.

- **While the outlook is positive, there are of course challenges**
  On the macro front, the key challenge in the near term is to contain inflation, which has risen above the authorities' target range, to 4½% on rising food and commodity prices and, increasingly, demand pressures. The Bank of Korea (BOK) raised interest rates on March 10 for a fourth time since last July. Further rate hikes are expected but at a gradual pace, as signaled by the BOK.

- **Beyond inflation, the main risks to the near term outlook are rising international oil prices and weaker external demand**
  External risks have increased in light of developments in Japan from the recent earthquake. Although it is still early to assess, prospects are good that the economic fallout on Korea will be relatively modest, coming primarily through temporary disruptions to supply chains. On the other hand, positive offsets could occur from a gain in competitiveness and market share for Korean exporters.

- **In the banking sector, household debt, reliance on wholesale funding, and high external short-term borrowing pose risks**
  These risks have been well-recognized by the authorities and are diminishing over time. Importantly, the supervisory authorities have been proactive in implementing measures to reduce financial sector risks, with a key policy focus now on limiting a further build-up of household debt.

- **Overall, vulnerabilities have continued to decline since the global financial crisis of 2008-09**
  Sovereign risk is low given modest fiscal deficits and a low public debt ratio. The banking system is well-capitalized, and vulnerabilities have declined on strong economic growth and improvement in global financial conditions.

- **Tensions with North Korea have heated up over the past year, and continue to weigh on investor sentiment**
  That said, the attitude among much of the population in South Korea toward relations with the North continues to be "business as usual," with prospects of a significant escalation in conflict viewed as unlikely.

Economic developments

Strong growth, with inflation the major concern

Korea was one of Asia's most affected economies during the 2008-09 global financial crisis, with negative impacts transmitted through both trade and financial channels. However, it was also one of the fastest to rebound. A proactive policy stance, and a sharp rebound in exports led to a "V-shaped" recovery, with growth in 2010 rebounding to 6.1% from 0.2% in 2009 (Table 1 and Figure 1).

The major growth driver has been exports, which have benefitted from a competitive advantage through a depreciated currency (the Won) and from strong brand recognition that have made its consumer products attractive not only in Western markets, but increasingly in China's rapidly growing consumer market (China has become Korea's largest trade partner). Strong export growth in turn has spurred domestic demand, particularly private consumption and facilities investment in the IT sector.

Table 1:
Korea economic outlook (Baseline scenario)

	2007	2008	2009	2010E	2011F	2012F
Real GDP growth (YoY%)	5.1	2.3	0.2	6.1	4.5	4.5
Private consumption (YoY%)	5.1	1.3	0.2	4.1	4.0	4.6
Investment (YoY%)	4.2	-1.9	-0.2	6.5	3.9	6.9
Inflation (YoY%, avg)	2.5	4.7	2.8	3.0	3.4	3.0
Foreign exchange rate (KRW/USD, eop)	931	1362	1163	1146	1000	988
Policy rate (%, eop)	5.0	3.0	2.0	2.5	3.5	4.0
Fiscal deficit (% of GDP)	-0.4	1.5	4.1	1.4	0.8	0.4
Current account (% of GDP)	0.6	-0.6	5.1	3.5	2.5	2.3

Source: BBVA Research

Korea has enjoyed investment–grade ratings by the major agencies since 1999. In recognition of its growth resilience and healthy public finances, Moody's upgraded the sovereign rating to A1 from A2 last April. Meanwhile, Fitch and S&P maintain ratings of A+ and A, respectively. All three agencies hold a stable outlook.

Inflation has become the main policy concern in recent months. As elsewhere in the region, inflation pressures are accelerating from both supply and demand factors. Headline inflation for the first two months of this year has exceeded the government's 2-4% target. In February inflation accelerated to 4.5% y/y, well ahead of expectations. Rising food prices have been a major driver since last September, from adverse summer weather conditions and a recent nationwide outbreak of food-and-mouth disease. Soaring international oil prices have also contributed. On the demand side, strong growth and the elimination of the output gap have generated pressures, as seen in a pickup of core inflation to 3.1% y/y in February.

In response, the policy focus has shifted from growth to price stability. The Bank of Korea (BOK) was slow to begin raising interest rates, in part because of a priority on sustaining the recovery, and also from worries about the impact of higher borrowing costs on household balance sheets. But with growth momentum now strong that has changed, with the government declaring a "war against inflation" and giving its tacit approval to gradual rate increases by the BOK.

Since last July, the BOK has hiked policy rates four times, by 100bps in total, to 3.0%. The BOK has signaled further rate hikes, but at a gradual pace. For its part, the government has implemented complementary supply side measures to reduce inflation, including the stabilization of government-controlled prices and liberalization of selected food imports.

Fiscal policy is similarly being normalized following the stimulus measures in 2008-09. The fiscal deficit in 2010 was 1.5% of GDP (estimated), down from 4.1% in 2009 (excluding social security contributions) as temporary stimulus measures were withdrawn. The public debt-to-GDP ratio is declining from modest levels, and is around 32% of GDP.

Despite persistent current account surpluses, currency appreciation has lagged behind that of regional peers, and has helped to give Korean exporters a competitive edge (Figure 2). Large capital inflows in 2009-10 led to rapid reserve accumulation as the BOK intervened to slow appreciation and replenish reserves. However, capital inflows have since eased on global risk aversion, as well as from tensions with North Korea. Implementation of "macro-prudential" measures to stem capital inflows (see below) may also be a factor.

The authorities have defended their macro-prudential measures on grounds that they are useful in reducing vulnerability to sudden capital reversals, as occurred in 1997 and 2008. These measures include: (i) a 14% withholding tax on foreign purchases of government bonds announced last November (which has little impact in reality given tax treaties with the countries of most foreign investors); (ii) tighter limits imposed last June on foreign currency forward positions (50% of capital) and foreign banks (250% of capital); and (iii) a proposed bank levy on non-deposit foreign currency liabilities (the measure is controversial and has not yet been passed by Parliament).

Outlook for 2011 and the medium term

Growth underpinned by strong domestic and external demand

We expect external and domestic demand to contribute about evenly to Korea's economic growth in the period ahead. GDP growth is expected to moderate to 4.5-5.0% in 2011. Private consumption will be underpinned by strong consumer confidence and low unemployment (around 3½% at present, close to its historic norm), with strong facilities investment expected to continue in the IT sector. Export growth is expected to remain strong, a byproduct of Korea's gains in market share and export diversification in recent years. Strong export sectors include shipbuilding, autos, telcom, petrochemicals, semiconductors, and steel.

The government's growth target for 2011 is 5%, and the BOK may well increase its previous 4.5% growth projection due to recent strong trends in exports and investment, and an improvement in the global outlook. Potential growth is estimated at 4% or above in the coming years.

Inflation is the main cloud on the horizon. Our previous 2011 inflation projection of 3.4% (average) now appears on the low side. Inflation is expected to remain high, until at least the second half of the year: the BOK expects inflation to exceed the 2-4% target during the first half of the year, before easing to the 3% range during the second half.

As noted above, monetary policy is expected to be gradually tightened during the remainder of the year. We expect two more 25bp interest rate hikes, with the BOK moving gradually, especially in light of renewed uncertainties from the Japan earthquake.

The fiscal stance is expected to be further normalized, as noted above, with a projected deficit of 1.5% of GDP in 2011. The government is targeting fiscal balance by 2013-14, mainly through expenditure restraint. That said, challenges to the medium-term fiscal outlook stem from an aging population and uncertain costs associated with an eventual (but by no means certain) reunification with the North. There are also contingent liabilities associated with loan guarantees and public enterprises. Data is limited, but such debt is believed to be around 35% of GDP, one-third of which is accounted for by the Korea Land and Housing Corporation. These liabilities are considered to be manageable, and the government has recently begun exercising greater control over the debt management of public enterprises. The over-extended Korea Land and Housing Corporation, which supplies affordable housing, has been cited as an agency that may be in need of government assistance in the future.

We do not expect the recent earthquake and disruptions in Japan to have a significant negative impact on Korea's economic outlook. First, the economic impact on Japan itself is expected to be limited (see *Economic Impact of Japan Quake*), and second Japan accounts for only 6% of Korean exports. Borrowing from Japanese banks amounts to $40.4 billion (BIS data), a significant sum (total external debt amounts to $360 billion), but credit lines from Japan are not expected to be withdrawn. One source of concern is the possibility of supply disruptions, as some high-tech Korean exporters rely on Japan for imported components. On the other hand, the appreciation of the Yen and difficult conditions for Japanese exporters create opportunities for Korean firms in competing industries.

Risks from the external environment and high household debt

The main risks to the outlook stem, on the external side, from the possibility of a sustained increase in oil prices, weaker external demand, and tensions with North Korea. On the domestic side, other than higher inflation, which could necessitate more forceful action by the BOK on interest rates, the main risks are from a high level of household debt (see below):

- External risks: as in other oil importing countries, a sustained increase in oil prices could frustrate efforts to contain inflation and could slow growth momentum. Risks to the balance of payments, however, are minimal given Korea's large current account surpluses and high level of reserves. If the global recovery were to weaken, exports would suffer, with knock-on effects to domestic demand. Given its openness and heavy reliance on foreign borrowing (external debt amounted to USD360 billion at end-2010), Korea remains vulnerable to a sudden stop in global capital flows. However, such vulnerabilities have been reduced since 2008-09 given policies to strengthen the financial sector (below), and the increase in foreign exchange reserves ($298 billion).
- Domestic risks: a key focus of policy is the highly indebted household sector. Household debt has risen steadily, reaching Won 770 trillion in the third quarter of 2010, equivalent to over 60% of GDP and implying a debt-to-income ratio of 153%, above Japan (135%) and the US (128%), but lower than the UK (169%). Such a high level of household debt could pose a systemic risk to the banking sector in the event of a sharp economic slowdown or fall in housing prices (mortgage debt accounts for more than 70% of household debt), and acts as a constraint on the BOK's willingness to raise interest rates more forcefully. That said, delinquency rates remain low at present, and the debt is believed to be concentrated among high-income households who have a high capacity to repay.

Relations with North Korea

Business as usual, despite heightened tensions

North and South Korea have remained in a technical state of war since 1953. Although the reclusive North has behaved belligerently from time to time, no full-scale conflict has erupted since the ending of the Korean War, and the two sides have managed to co-exist with infrequent military skirmishes.

Despite a recent increase in tensions (see below), South Koreans tend to view the impoverished North as a nuisance, rather than a serious military threat. Many South Koreans hope to see eventual reunification, even though tensions remain and the medium-term financial costs of reunification would be very large (as with West and East Germany). Economic conditions in North Korea are often described as dire; nevertheless, the regime has considerable staying power given its scope for repression and political support from China.

Inter-Korean relations worsened over the past year with the deadly sinking of a South Korean navy ship in April and the shelling of a South Korean island near the border in November. The motivation for the North's aggression has never been clear, although it is widely attributed to the regime's efforts to attract attention and gain concessions in the form of economic assistance, especially during periods of domestic economic hardship.

In contrast to its predecessor, the ruling South Korean government led by President Lee Myung-bak has taken a hard stance against the North, and is under increasing domestic criticism for not resuming talks (the South Korean government's term expires in early 2013, with Presidential elections scheduled in 2012). Tensions have eased since the shelling in November, but could rise again at any time. The regime in the North is unpredictable, and events will be influenced by the political succession from the current leader Kim Jong-il to his youngest and reclusive son Kim Jong-un.

Outlook for the financial sector

Vulnerabilities declining on improved financial conditions and strong policies

The outlook for the financial sector has improved significantly following the difficulties it faced during the 2008-09 crisis. The crisis exposed vulnerabilities stemming from banks' reliance on wholesale funding and external borrowing. The authorities took a series of steps at the time to ease funding pressures and ensure adequate bank capital adequacy. Since then, measures have been taken to reduce the sector's vulnerability over time, and risks are manageable.

The improving trends have continued over the past year, with most soundness indicators remaining stable (Figure 2). The system is well-capitalized, with average CARs of 14.6% at end-2010. The ratio of non-performing loans is low at 1.3%, but still above what the authorities would like to see. NPLs rose slightly in the second half of 2010 due the supervisor's (FSS) tightening of loan classification standards in the troubled construction sector. Loan-to-deposit ratios (LDR) have continued to decline, and the government has imposed a cap of 100% by end-2013 (LDRs are currently around 100%). The authorities believe that Basle III will have limited impact given banks' already high CARs, although some banks will need to adjust to meet more stringent liquidity coverage ratios.

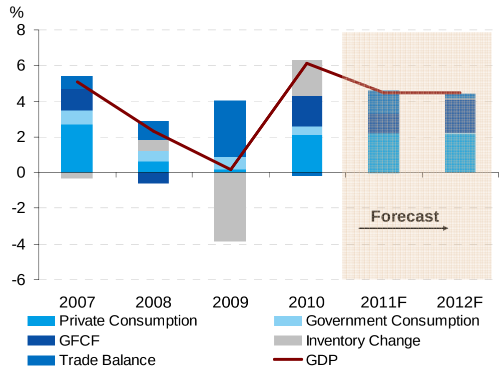
One recent area of vulnerability has been the savings bank sector. There are at present a little over 100 savings banks nationwide, down from more than 200 a decade ago. Some of these banks recently experienced deposit runs due to shortages in liquidity arising from weak loan quality in the construction/property sector. Eight of them were suspended in the past month. The authorities have announced measures to improve governance and supervision of the sector, and to provide a fund to support restructuring of the sector. The savings bank sector accounts for around 5% of total banking system assets, and does not therefore pose a systemic risk.

Lending growth remains sluggish at around 2-3% y/y, especially in comparison to the pick-up in credit growth seen in other Asian economies. This mainly reflects a deleveraging process and slowdown in lending to the SME sector in particular, following the rapid lending rates pre-crisis. Other credit segments have grown more rapidly, including mortgages and corporate loans.

Over the medium-term, the authorities have initiated plans to develop Seoul and Pusan as regional financial hubs for North Asia. They do not seem themselves as competing with established financial centers such as Hong Kong and Singapore, but rather see an advantage in niche markets, especially asset management and shipping financing.

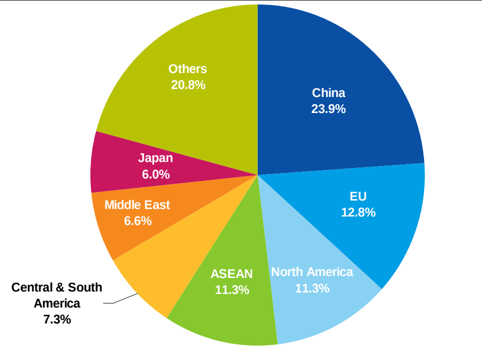
Figure 1
Recent economic developments

GDP growth is moderating at a relatively high trend level



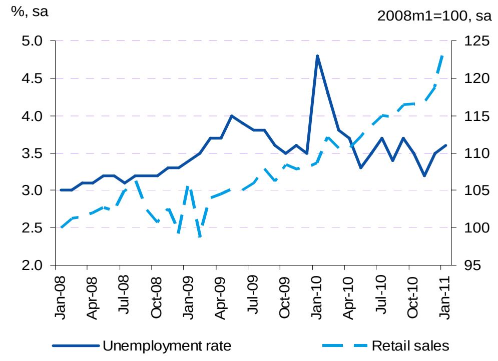
Source: CEIC and BBVA Research

China is Korea's single largest export market, while Japan's share is correspondingly small



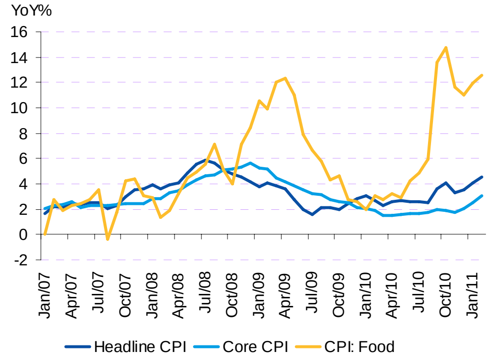
Source: CEIC and BBVA Research

Domestic demand (retail sales) remains strong as labor market conditions improve



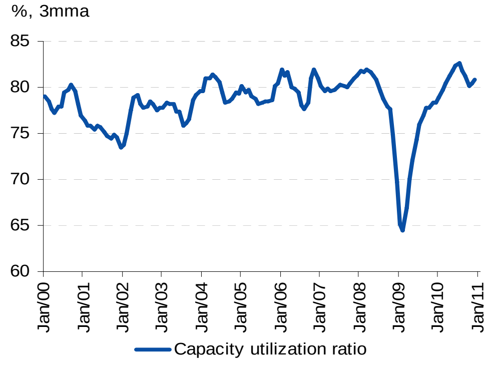
Source: CEIC and BBVA Research

Inflation accelerated initially on food prices, but rising core inflation indicates that demand pressures are now at play



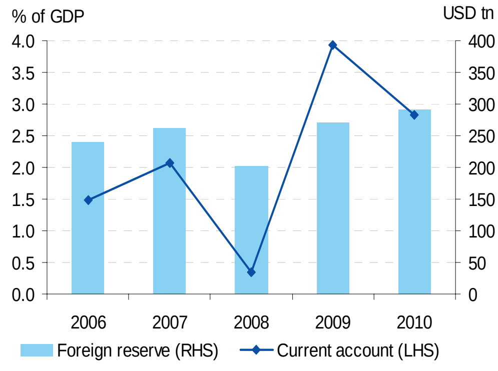
Source: CEIC and BBVA Research

Capacity utilization rates are at or above historic norms, indicating little or no spare capacity



Source: CEIC and BBVA Research

Foreign reserves have increased since 2008, and the current account is in surplus



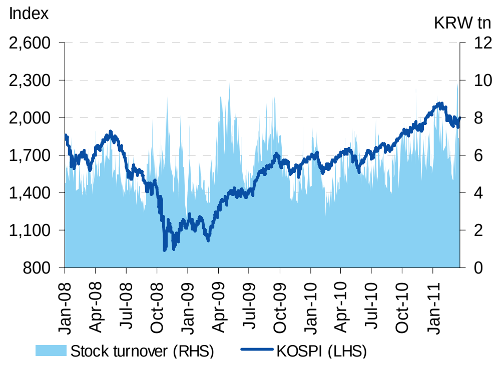
Source: CEIC and BBVA Research

Figure 2
Asset market development

Korea's CDS spreads have declined markedly

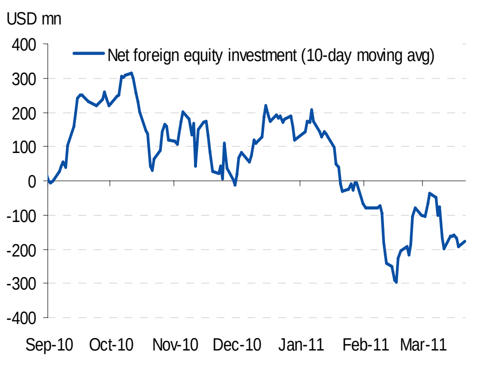
Source: CEIC and BBVA Research

Sound growth prospects and capital inflows propelled the stock market in 2010, although it has corrected more recently



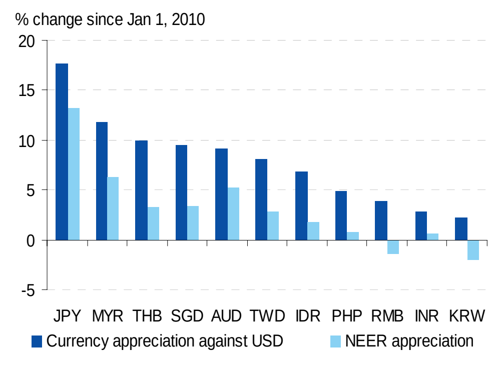
Source: Bloomberg and BBVA Research

Equity inflows have eased on global risk aversion and tensions with the North



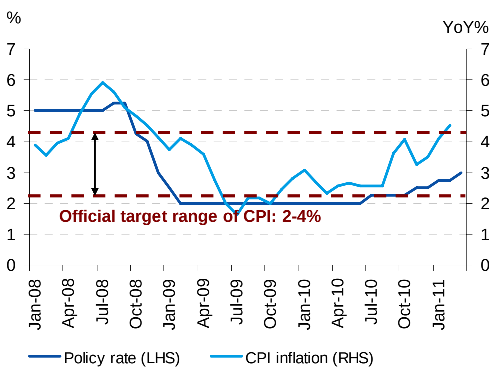
Source: Bloomberg and BBVA Research

Won appreciation has lagged regional peers



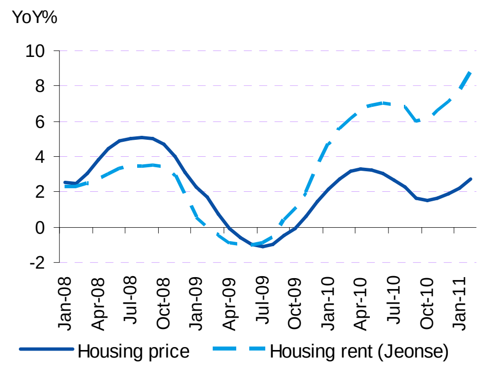
Source: CEIC and BBVA Research

Interest rate increases have been lagging behind the pickup in inflation



Source: CEIC and BBVA Research

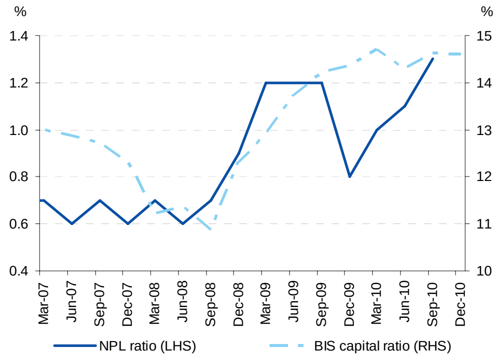
In the property sector, nation-wide rents have outpaced purchase prices as home-dwellers opt to rent rather than buy



Source: CEIC and BBVA Research

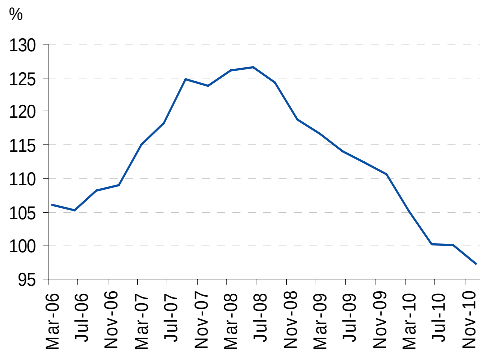
Figure 3
Outlook for the financial sector

The banking sector is well-capitalized, with low NPLs…



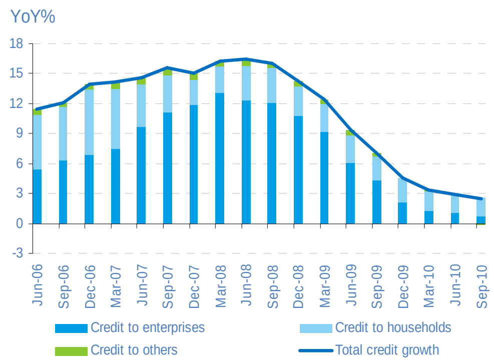
Source: CEIC and BBVA Research

...and a fall in loan-to-deposit ratios are helping to reduce vulnerability



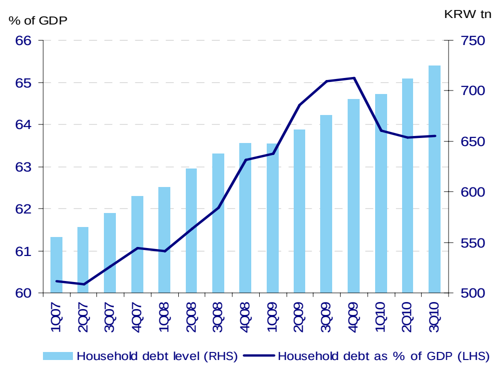
Source: CEIC and BBVA Research
Note: The loan-to-deposit ratio is calculated by using won-denominated loans and deposits (excluding CDs) of commercial banks

Credit growth remains sluggish on cautious lending to enterprises, especially SMEs



Source: CEIC and BBVA Research

Household debt is high



Source: CEIC and BBVA Research

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