South Korea

Double whammy

Korea's economic growth prospects have continued to deteriorate. Recent trade tensions with Japan have come on top of the slowdown of the Chinese economy and in global demand as well as the conflict between the United States and China, hitting exports and investment. The authorities have some scope to stimulate domestic demand. As has been the case for several years now, fiscal policy will remain expansionary in 2020, whilst the central bank could cut its policy rate in the short term. Stimulus measures will nevertheless not be enough to boost economic growth significantly in 2020.

A further slowing of growth

Having grown by 2.7% in 2018, real GDP growth slowed significantly in the first half of 2019 (1.9% y/y). Non-construction investment fell by an average of 6.5% over the first two quarters of 2019 and spending on capital goods fell by more than 17% over the same period, a direct consequence of the difficulties experienced in the semiconductor sector and the trade war between China and the United States. In addition, the macro-prudential rules introduced by the government at the end of 2017 (intended notably to control the growth in household debt) have held back investment in construction. In total, investment fell for the fifth consecutive quarter, dropping by 3.4% (y/y) in Q2 (Chart 2). At the same time, private consumption stabilised at 1.0% in the first half of 2019, having slowed throughout 2018. All the available figures for the third quarter (retail sales, industrial production and the PMI) suggest a further slowing in the third quarter.

Most importantly, exports collapsed, dropping 11.7% y/y in September, after a 13.8% fall in August. Over the last nine months of the year they fell by nearly 10% y/y, having grown by 6% in 2018. Exports to China fell particularly sharply, reflecting both the weakness of global demand – China remains at the centre of the Asian value chain even though its structure is changing – and the slowing of the Chinese economy, which is becoming an increasingly important source of final demand. The worst affected sectors were exports of semiconductors and electronic goods, which saw heavy falls. Nor are prospects particularly favourable: Chinese growth is likely to slow further, and trade tensions between China and the United States persist. In addition, the Korean export sector will be further put to the test over the coming quarters: since the beginning of the summer, the diplomatic conflict between Japan and Korea has heated up, leading to restrictive trade measures between the two countries.

Tensions with Japan

The tensions between Korea and Japan flow from an historical and political conflict that has rumbled on for many decades[1]. Recently, the re-emergence of disagreements relating to colonial reparations have revived tensions between the two countries.

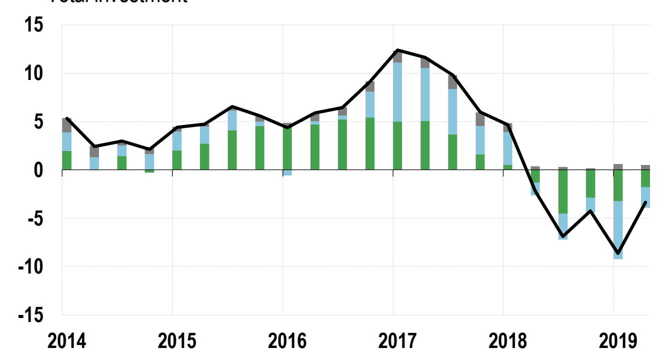
[1] Korea was colonized by Japan between 1910 and 1945. In 1965, after 14 years and 7 cycles of negotiation, the two countries signed a treaty normalizing their relationship, particularly on the economic front. Since then, the relationship between the two countries has nevertheless been strained.

1-Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	3.2	2.7	1.9	2.1
Inflation, CPI, year average (%)	1.9	1.5	0.9	1.5
Gen. gov. balance / GDP (%)	1.4	1.4	0.3	-1.6
Gen. gov. debt / GDP (%)	40.4	39.5	37.1	39.8
Current account balance / GDP (%)	5.1	4.8	4.3	4.1
External debt / GDP (%)	27.7	28.3	28.6	28.6
Forex reserves (USD bn)	384	404	405	405
Forex reserves, in months of imports	7.9	7.3	7.5	7.5
Exchange rate USDKWR (year end)	1 130	1 122	1 200	1 100

e: BNP Paribas Group Economic Research estimates and forecasts

2- Investment



Source: National Accounts

On 1 July 2019, the Japanese Prime Minister announced restrictions on the export to Korea of a range of products, including three chemical products that are required for the production of semiconductors, smartphone screens and TVs, which are key industries in Korea. Then on 2 August, the Japanese government announced that Korea had been removed from the list of countries with which Japan has favoured trade relations. The countries on this list are considered as "reliable" trade partners and, amongst other things, enjoy facilities relating to the import of "strategic" products (military material, sensitive chemical products). Conversely,

countries not on the list must request special authorisation for each product every 6 months, and the delay in this authorisation being granted can be up to 90 days. Korea will have to seek authorisations for more than 1,000 products, and the Japanese government could expand the list of products requiring special authorisation at any time.

In mid-September, the Korean government took a similar decision, removing Japan from the list of "friendly" trading partners. This decision comes a month after Korea decided not to renew an agreement on the sharing of military intelligence that had existed since 2016.

Repercussions for the export sector

At first sight, the consequences for the Korean economy are likely to be relatively limited: imports from Japan were less than 10% of the total in 2018 (with those from the United States and China representing 12% and 21% respectively), whilst exports to Japan account for 5% of the total (with 25% going to China and 12% to the US). In addition, in terms of value added, the move up market of Korean industry over the past decade has translated into a marked reduction in the share of Japanese inputs into the Korean production process.

This said, in 2018, 90% of imports from Japan were intermediate goods and capital goods. The vast majority of these imports consisted of chemical products, which represent intermediate goods for the semiconductor and base metals sectors and are precisely the products targeted by restrictions. Lastly, the Japanese companies supplying all these goods have dominant positions in the global market, making alternative supplies difficult to access for Korean companies.

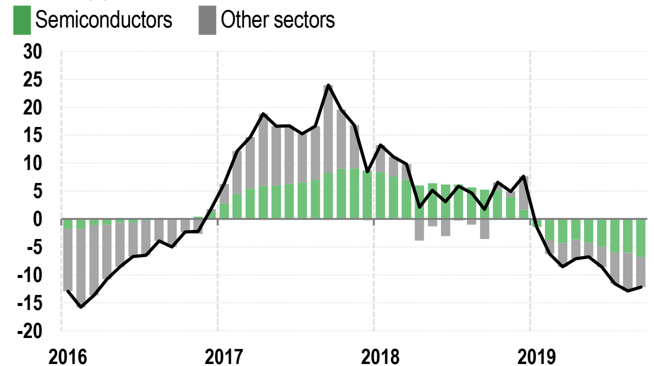
According to the Korean Ministry of Trade, at the beginning of October, that is to say three months after the measures were announced, authorisation requests for numerous products used in the semiconductor production chain had not been successful. The semiconductor sector in particular (but potentially a much broader segment of Korean industry) could find itself structurally weakened if delays in supply (or shortages in a more extreme scenario) persisted. More generally, given the high level of integration of the various economies in the region, the whole of the Asian value chain could be hit by delays in supply. Lastly, investor concern could mount, further holding back investment over the coming quarters.

Sources of support for investment

South Korea has solid macroeconomic fundamentals and the scope to support the economy. Falling inflation gives the central bank the option of cutting interest rates (currently at 1.25%) over the next few quarters.

Most notably, public debt is modest, at around 40% of GDP. When it presented its budget for 2020, the Korean government included a range of measures intended to support growth, particularly in investment. Under its 'growth through innovation' programme, the government plans to reduce dependence on imports, increase local competitiveness and accelerate Korean industry's move up the value chain. The three industries targeted by the programme

3- Exports



Source: Ministry of Trade, Energy and Industry

(semiconductors, biochemicals & healthcare and innovative vehicles) will receive additional support. In addition, research and development spending is likely to rise by nearly 20%, and spending relating to the manufacturing sector and SMEs set to increase by nearly 30% compared to 2019. Fiscal policy has been expansionary for several years now. According to government forecasts, if we take account of the social security surplus, the public finances are likely to be in deficit in 2020 (at 1.6% of GDP, compared to a surplus of 0.3% of 2019) for the first time since 2015. Without the social security surplus, the deficit would be 3.6% of GDP (from 2.0% in 2019).

All in all, given the frankly negative prospects for the export sector, stimulus measures are unlikely to be enough to offset the slowdown in growth in 2019 and 2020. Real GDP growth is unlikely to be significantly above 2.0% in 2019 and 2020.

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