SOUTH KOREA

POSITIVE OVERALL

Korea's solid macroeconomic fundamentals have made it one of the countries that has best withstood the COVID-19 pandemic. Economic growth prospects remain relatively positive. The new government, in office since May, spelled out its intention to continue the reforms begun during the previous administration, and, in particular, aims to increase research and development expenditure. Household debt rose rapidly in 2021 and is high, but the macro-prudential measures put in place by the authorities seem to be bearing fruit: the rise in debt has slowed and financial stability risks are contained.

A CHALLENGING EXTERNAL ENVIRONMENT

Korea has weathered the COVID-19 pandemic well. In 2020, real GDP fell by less than 1%. Despite several waves of infection, the effectiveness of the policies put in place (including the vaccination campaign) meant the economic recovery was not hampered and the country's financial stability was maintained. Real GDP returned to its Q4 2019 level from Q1 2021, rising 4.1% in 2021. The medium-term outlook remains favourable.

However, economic growth is expected to slow in 2022. It reached 2.9% year-on-year (y/y) in Q1 compared with 4.2% in the previous quarter: exports continued to grow vigorously (7.3% y/y in Q1 2022, after 7.9% y/y in Q4 2021), driven by global demand for semiconductors. Private consumption, on the other hand, lagged behind, hamstrung by new restrictions (4.3% y/y in Q1 2022, after 6.2% y/y in Q4 2021).

As the international environment deteriorated, activity slowed further in Q2 2022 and inflation continued to accelerate. The new export orders index fell sharply in April and, by the beginning of July, it was still below the level seen in March. Exports have slowed (increasing by 13.2% y/y after 18.4% y/y in Q1) and the manufacturing PMI fell during the quarter. Inflation reached 5.4% y/y in May, the highest rate in more than a decade.

Firstly, lockdowns imposed in China in the spring as part of its "zero covid" policy weighed on Korean exports and production (by disrupting the supply of intermediate goods). Secondly, although the direct consequences of the war in Ukraine are modest for Korea (trade and financial links with the two countries are limited, and energy dependence on Russia is low), the indirect consequences of the conflict weigh on growth. Slowing global demand is slowing exports and, above all, rising energy and agricultural commodity prices are contributing to higher Korean inflation and are slowing the growth of private consumption and investment.

SLOWER THAN EXPECTED FISCAL CONSOLIDATION

Since 2020, the authorities have benefited from their significant fiscal leeway to massively support the economy. In total, support measures represented almost 10% of GDP over the past two years, and the IMF estimates that other measures, for an amount that is also close to 10% of GDP, have been financed off-budget.

The resurgence of the pandemic in Q1 and inflation pressures has prompted the government to twice announce further support measures since the beginning of 2022 for a total amount close to 5% of GDP. The targets in terms of fiscal consolidation have therefore been revised downwards: the deficit is now expected to stand at 3.3% of GDP in 2022 (after 4.4% in 2021) compared with 2.5% previously. However, slower

FORECASTS

	2019	2020	2021	2022e	2023e
Real GDP growth (%)	1.8	-0.9	4.0	2.7	2.1
Inflation, CPI, year average (%)	0.4	0.4	2.5	4.6	2.6
Gen. gov. balance / GDP (%)	-0.6	-5.8	-4.4	-4.2	-4.5
Gen. gov. debt / GDP (%)	39.5	44.0	47.4	49.8	52.1
Current account balance / GDP (%)	3.6	4.6	4.9	2.8	2.5
External debt / GDP (%)	28.4	30.1	31.8	30.8	29.8
Forex reserves (USD bn)	404	408	463	450	465
Forex reserves, in months of imports	7.5	7.5	7.3	6.9	7.4

TABLE 1
e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

SOUTH KOREA: CONTRIBUTION TO REAL GDP GROWTH

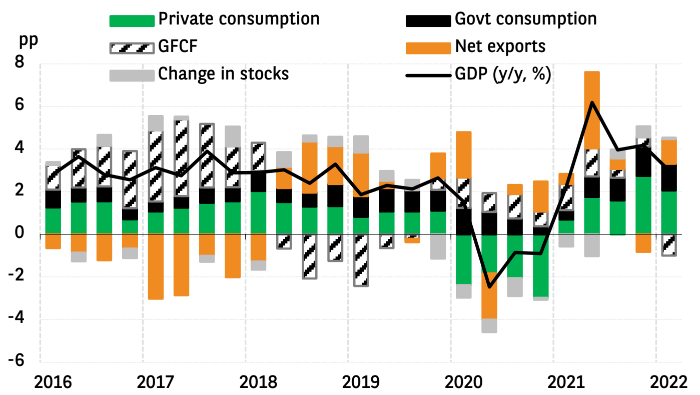

CHART 1
SOURCE: CENTRAL BANK

economic growth and persistent inflation pressures lead us to believe that further support measures will be announced in Q3. We expect a slightly lower deficit, but above 4% of GDP in 2022.

CONTINUATION OF THE KOREAN NEW DEAL

For the time being, the increase in the price of neon (a noble gas, over 70% of which is produced in Ukraine, that is involved in the semiconductor manufacturing process and whose price tripled year-on-year in Q1 2022) has not really had a direct effect on semiconductor production. Korean companies have used their existing inventories and have benefited from the strategy of diversifying imports and increasing local production, which has been in place for several years.

That said, in the very short term, Russia and Ukraine remain the main producers of raw materials needed for semiconductor production. Disruptions in the electronic and technological value chains are therefore weighing on Korean growth prospects.

In the medium term, Korean growth should continue to be driven by increased investment and production capacity in the semiconductor sector. The Korean New Deal (a large set of measures adopted in July 2020, intended, among other things, to improve the country's energy transition and, above all, "digitalisation") had already made it possible to increase incentives to invest in this sector, and the new President, Yoon Seok-youl (of the conservative "People Power Party" and elected at the beginning of March), plans to continue this development strategy. Among the 110 proposals in his roadmap, unveiled at the beginning of May when he entered office, are the continuation of the investment strategy and the strengthening of innovation capacities included in the Korean New Deal. The focus will be on public-private partnerships, creating highly skilled jobs and increasing domestic production of high value-added manufactured products. The government also announced its intention to fund research and development programmes to increase domestic production of krypton and xenon.

HOUSEHOLD DEBT STABILISED AT A HIGH LEVEL

Faced with inflation pressures, the Central Bank began its tightening cycle from August 2021. The main policy rate has been raised five times since then to 1.75% (by a total of 125 basis points). Inflation pressures are expected to persist in the short term but be transitory: average inflation is expected to be 4.6% in 2022. Further rate hikes are expected this year.

At the same time, the combination of a very limited housing supply and historically low interest rates have pushed up house prices. At a national level, the property price index has risen by more than 19% in 2021, and by more than 30% since the beginning of 2020. Similarly, household debt has risen rapidly, reaching 105% of GDP in Q1 2022, compared with 95% in Q4 2019.

That said, growth in household debt seems to have stabilised over the last two quarters. The measures taken by the government to stabilise the housing market (in particular, by increasing the supply of available housing) seem to have paid off. Household credit growth slowed sharply in Q1 2022 (to 5% year-on-year, after having increased by almost 10% on average between Q4 2020 and Q4 2021), and the new government has set itself the target of keeping growth in household debt at under 5% for 2022, then gradually reducing the gap between the growth rate of household debt and that of nominal GDP.

However, the risks associated with household financial stability remain contained: according to a study by the Central Bank, household debt levels are not high enough to restrict consumption. The debt structure is also favourable: a very large majority of borrowers are "high-income borrowers", for which the loan-to-value ratio (LTV ratio) is low.

Article completed on 1st July 2022

Hélène DROUOT
helene.drouot@bnpparibas.com

SOUTH KOREA: HOUSEHOLD DEBT

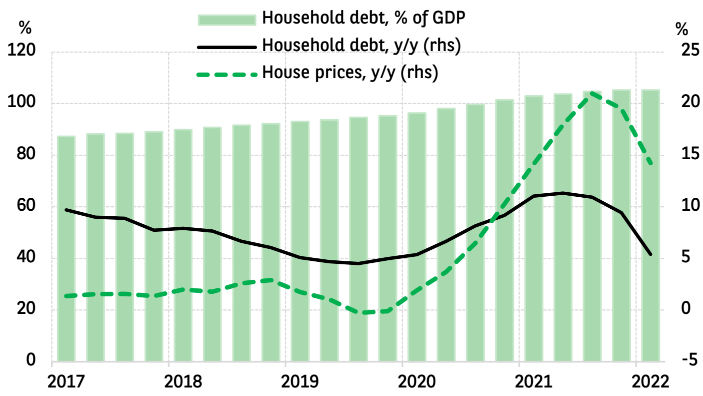

CHART 2
SOURCE: CENTRAL BANK