# SOUTH KOREA



## RESILIENT

**Once again, South Korea seems to be withstanding the crisis better than developed nations generally. The effective management of the health crisis and the government's massive stimulus package paved the way to a shallower recession than in other countries in the first half of 2020. However, the new social distancing measures introduced at the end of August and the persistent weakness of exports will hold back growth over the coming months. In the short to medium term, macroeconomic fundamentals are likely to remain very solid: government deficit and debt levels remain modest, inflation is under control and external vulnerability is very low.**

### A SHALLOWER RECESSION

Compared to other developed nations, the recession expected in South Korea in 2020 is likely to be moderate. GDP is likely to contract by 1.3% in 2020, having grown by 2.0% in 2019 and an average of 2.8% per year over the past five years.

On the one side, effective management of the health crisis (with the government electing in January to pursue a policy of mass testing, contact tracing and isolation of cases) allowed a relaxation of restriction on the movement of individuals and on economic activity earlier than in other countries and for a national lockdown to be avoided.

On the other side, solid macroeconomic fundamentals (at the beginning of 2020 government debt and the deficit were modest, inflation was under control and external vulnerability was very low) allowed the government to step in to support the economy: a number of programmes (four so far) have been announced by the government since March, including both short-term measures (to support the most vulnerable households and SMEs) and other more long term actions. Announcements in July included most notably the "Korean New Deal": a 5-year investment plan, which aims to "digitalise" the economy, promote "ecological and environmental" projects and improve social coverage for the whole population. All in all, including both direct and indirect support (such as the extension of guarantees for companies and deferred payments of taxes and social security contributions), the measures taken are worth some 20% of GDP. At the same time, the Central Bank has cut its policy rate by 75 basis points since March (to 0.5%), announced several financial support packages (notably for vulnerable companies) and undertaken to provide substantial liquidity to companies.

All in all, GDP fell by 'only' 0.7% y/y in the first half, and private sector demand proved fairly resilient: private consumption fell by 4.5% y/y in the first half, whilst investment grew by 3.3% y/y, illustrating the flexibility of the Korean economy. To no great surprise, however, exports collapsed rapidly in the second quarter (down 13.0% y/y in real terms), despite the support provided by growth in semiconductor exports. The latter was driven by strong demand for chips (components in laptop computers and networking equipment) in response to the rapid growth in remote working.

| FORECASTS | 2018 | 2019 | 2020e | 2021e |
|---|---|---|---|---|
| Real GDP growth (%) | 2.7 | 2.0 | -1.3 | 2.7 |
| Inflation, CPI, year average (%) | 1.5 | 0.4 | 0.4 | 1.1 |
| Gen. gov. balance / GDP (%) | 1.4 | -0.6 | -4.4 | -4.3 |
| Gen. gov. debt / GDP (%) | 39.5 | 39.5 | 44.0 | 44.3 |
| Current account balance / GDP (%) | 4.8 | 3.6 | 1.0 | 2.5 |
| External debt / GDP (%) | 25.6 | 28.4 | 30.1 | 30.4 |
| Forex reserves (USD bn) | 398 | 404 | 400 | 402 |
| Forex reserves, in months of imports | 7.2 | 7.5 | 7.5 | 7.3 |
| Exchange rate USDKWR (year end) | 118 | 1 158 | 1 210 | 1 210 |

TABLE 1

e: ESTIMATES AND FORECAST
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

GDP (%, YOY) AND COMPONENTS (IN PERCENTAGE POINTS)

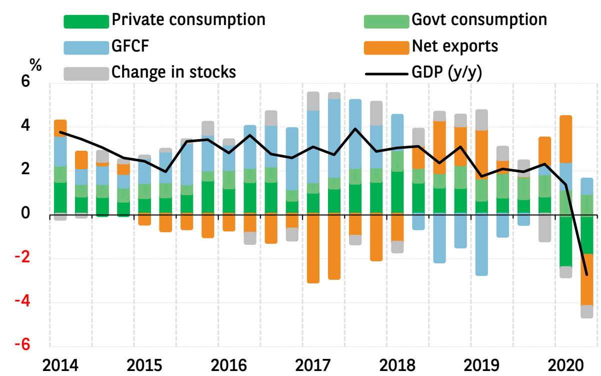


CHART 1

SOURCE: NATIONAL ACCOUNTS

### A GRADUAL RECOVERY RATHER THAN A REBOUND

The economic recovery will be gradual. The indices of industrial production and retail sales have recovered steadily since April, but there are several factors that constrain the recovery in the short term. We expect GDP growth of 2.3% in 2021.

First, the government reintroduced social distancing measures at the end of August after a fresh increase in the number of cases. New cases hit 400 per day at the end of the month, compared to an average of 44 between 15 March and 15 August. In the first wave of the epidemic the peak came on 29 February with 909 new cases. The restrictions were eased in mid-September (when the number of new cases had stabilised at around 100 per day), but remained at 'level 2' for an indefinite period in the Seoul region (remote working and remote learning where possible, limitations on meetings and so forth). Over the next few days, the government is due to present the new national measures to establish a *"cautious strategy balancing economic growth and tackling the virus"*. These measures will hit private consumption in the final quarter (particularly demand for services) and at the beginning of 2021 – but probably less hard than in the first half of this year.

Secondly, although exports may recover in the very short term, global demand will remain lastingly weakened, which will hit Korean exporters accordingly. The tensions between the USA and China will hit Korean exports particularly hard, given both the high level of Korea's integration in regional value chains, and the importance of the two countries as trading partners (as sources of final demand). A sign of this vulnerability came in the 10% y/y (in current dollars) fall in Korean exports in 2019 as Sino-US tensions rose, whilst Taiwan's exports fell by only 2% over the year (and Chinese exports fell only very slightly). Similarly, although Chinese and Taiwanese exports recovered in the summer of 2020, Korean exports continued to fall (down 9% y/y in July and August). Korean exports to China fell by 16% in 2019 and then by 5% in the first 8 months of 2020.

Tourism revenue will also be weak over the next few quarters, although the effect on growth will not be as significant as for other countries in the region. In the strict sense of the term, tourism revenue accounts for 2% of Korean GDP, compared to nearly 12% for Thailand for example.

Lastly, in the absence of any further stimulus measures, the contribution of public consumption to growth is likely to decline. In its budget proposals, set out in mid-September, the government allowed for an increase in spending of only 1% relative to the total for 2020 (which saw an increase of nearly 15% relative to 2019, after the four successive stimulus packages are taken into account).

## SOLID MACROECONOMIC FUNDAMENTALS HELP ABSORB THE CURRENT PRESSURES

South Korea's macroeconomic fundamentals look set to remain solid over the short term. External vulnerability remains extremely low. The current account is likely to worsen but remain in surplus (with an expected surplus of 1% of GDP, from 3.6% in 2019). Moreover, the external financial position has improved continuously since 2010 and was close to 36% of GDP at the end of Q2 (from just below 20% at the end of Q4 2019), creating strong protection against episodes of capital flight.

Meanwhile, the public finances were on a very sound footing before the four stimulus packages announced this year, so should come under only limited pressure. The first reason for this is that the private sector (including financial institutions) will make a substantial contribution to the financial support provided to companies. Secondly, as early as the 2019 budget, the government was setting out an economic policy of "income-driven growth", the aim of which was to improve redistribution by increasing public spending. The "Korean New Deal" set out in July continues this work. The total government deficit is likely to be 4.4% of GDP in 2020, from 0.6% in 2019. Government debt is likely to rise from 39.5% of GDP in 2019 to 44% in 2020. If the government applies the programmes it has announced effectively, we would expect that deficit and debt will stabilise at around these levels over the next few years.

The profile of government debt is favourable: the maturity of treasury bonds is long (more than 10 years) and the investor base is diverse both domestically and internationally. Lastly, the share of treasury

NET EXTERNALPOSITION (% GDP) AND ITS COMPONENTS (USD BN)

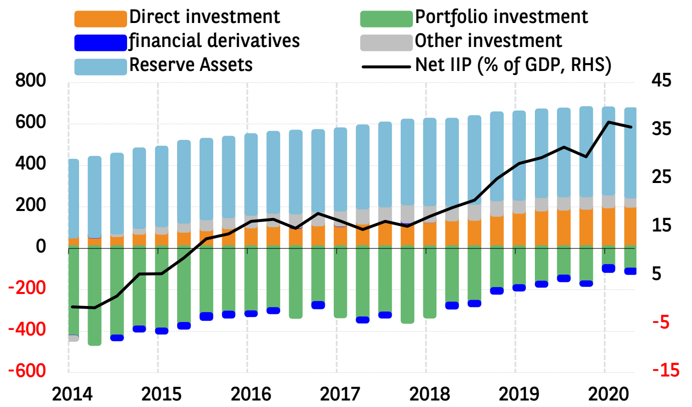


CHART 2

SOURCE: CENTRAL BANK

bonds held by foreign investors has recently risen slightly, but remains moderate (at 17% in July 2020, having been stable at around 15% since 2015). In addition, the contingent debt relating to public companies remains high (estimated at 26% of GDP at end-2019), but has declined steadily since the introduction of the restructuring plan in 2013, when contingent debt stood at over 35% of GDP.

Lastly, the banking system taken as a whole is solid and well-placed to absorb a temporary deterioration of asset quality. Bank profitability will decline over the next few quarters, but the support measures introduced by the government and central bank will help them absorb the shock. All this said, there are still a number of possible weaknesses that will need to be watched: the vulnerability of several regional banks has increased (in the regions where social distancing measures have been stricter) and the same is true of certain export sectors (notably the automotive and shipbuilding sectors). In addition, although the associated risk is considered moderate in the short term, household debt is high (103% of GDP at the end of Q1 2020). The macroprudential measures introduced in 2017 have slowed the growth in lending to households, but the profile of their debt remains a source of vulnerability, particularly as 50% of this debt is still in the form of floating-rate loans.

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