SOUTH KOREA

LIMITED POTENTIAL CREDIT RISKS

Korean economic growth lagged behind in Q4 2022, and the slowdown is expected to continue in 2023. Exports will suffer from slowing global demand, while domestic demand will be penalised by rising interest rates and persistent inflation. The risks of financial instability remain limited, but have increased in recent months. Household debt is high at almost 110% of GDP, and households are very exposed to rising interest rates. In fact, 76% of loans to households are being taken out at a variable rate. Potential credit risks though remain limited to the most vulnerable households.

SLOWING EXPORTS

Real GDP growth slowed in 2022 (to 2.6%, from 4.1% in 2021). After holding up relatively well over the first three quarters despite tighter financial conditions, high interest rates and slowing global demand, exports and consumption (public and private) lagged behind in Q4. Real GDP grew 1.4% YoY, after reaching 3% on average over the previous three quarters.

A more marked slowdown is expected in the coming months. Weak demand from Europe and the US is significantly impacting the performance of the export sector, and exports to China will not be enough to offset this slowdown. Exports fell by 12.5% YoY in Q1 2023.

Furthermore, the rapid downturn in the semiconductor cycle is also likely to penalise private investment, at least over the next two quarters. While the total industrial production index rose 2% YoY in February, the semiconductor production index fell by almost 40% YoY

High inflation and high interest rates will impact consumer spending and investment. According to data from the Central Bank, rising interest rates could particularly penalise small companies, which have fewer resources to absorb the rise in debt servicing costs, companies in the construction sector and households with debt.

Lastly, fiscal policy support should be much less significant than in the last three years. President Yoon (elected in May 2022) seems less inclined to support the economy than the previous government, in order to achieve the objective to which he has committed of consolidating public finances (reducing public spending). Last February, the Minister of Finance opposed the demand for support measures made by many MPs, aimed at supporting the most vulnerable households and businesses in the face of persistent inflation. Yet, the government announced in its 2023 budget that it would continue to support the economy, giving priority to strategic sectors for Korean industry, such as the semiconductor sector and new energies (with the objective of significantly reducing Korean dependence on fossil fuels).

We expect a recovery in investment and exports at the end of 2023, partly thanks to the upturn in the new technology sector. Overall, real GDP is expected to grow by 1.4% in 2023. In the medium term, Korea's industry could benefit from the global trend of a transition to electric vehicles and therefore from an increasing need for high-end batteries.

FORECASTS

	2020	2021	2022	2023e	2024e
Real GDP growth (%)	-0.9	4.1	2.6	1.4	2.0
Inflation, CPI, year average (%)	0.4	2.5	5.1	3.7	2.3
Gen. gov. balance / GDP (%)	-6.1	-4.4	-5.1	-3.5	-3.1
Gen. gov. debt / GDP (%)	44.0	47.4	49.8	51.2	52.1
Current account balance / GDP (%)	4.6	4.7	2.1	2.8	2.8
External debt / GDP (%)	33.5	34.9	40.0	34.9	32.7
Forex reserves (USD bn)	430	438	399	418	435
Forex reserves, in months of imports	7.5	7.3	6.9	6.8	6.5

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

SOUTH KOREA: INDUSTRIAL PRODUCTION INDEX

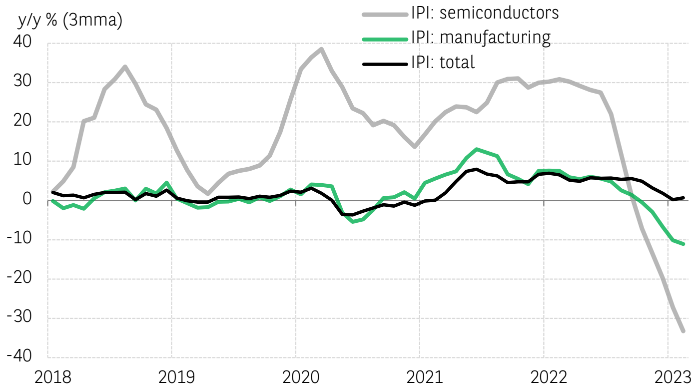

CHART 1 SOURCE: STATISTICS KOREA, BNP PARIBAS

MONETARY POLICY ON HOLD

Throughout 2022, the Central Bank of Korea continued the monetary tightening cycle initiated in August 2021. The main policy rate was raised seven times in 2022 and once in January 2023, bringing it to 3.5% (whereas it had been 0.5% since May 2020, a record low). The policy rate remained unchanged after the February meeting and is expected to remain at this level in the coming months. After reaching over 5% on average in 2022, the rate of inflation should in fact gradually slow over the coming months, thanks to the drop in the oil price and the slowdown in domestic demand. Convergence towards the Central Bank's target (2%) should, however, be gradual: the drop in agricultural commodity prices is being passed on relatively slowly, and inflation expectations remain high.

Furthermore, the Central Bank is reluctant to raise interest rates too aggressively. Given the close link between household debt and the real estate sector, rising interest rates and fluctuating asset prices pose risks to the most vulnerable households.

As the main structural weakness of the Korean economy, household debt has risen sharply in recent years, reaching 107% of GDP at the end of 2022. 76% of loans to households are still being taken out at a variable rate (and about 50% of new loans in January 2023), which leaves them very exposed to a hike in interest rates. According to the Central Bank's estimates, households' debt servicing could reach around 9% of their disposable income in 2023 (compared to almost 5.5% on average in 2010-2019).

The Central Bank intends to limit the impact on private consumption as well as an excessive correction in the real estate market. In fact, the rise in interest rates and a drop in consumer confidence have resulted in a downturn in the real estate market after several consecutive years of increase. Housing sales fell by more than 50% in 2022, after a decline of 21% in 2021, and the house price index already fell by nearly 6% between the peak of June 2022 and January 2023. However, the house price index remains higher than its level reached before the pandemic, while stocks of unsold housing continued to rise during H2 2022. In the short term, the price correction could continue.

CREDIT RISKS REMAIN LIMITED

Credit risks remain limited. Risks for the most vulnerable households have increased but overall, the amount of household financial assets is still twice as high as their debt. Last October, in response to the fall in property prices, the government announced a slight easing in regulations concerning the loan-to-value ratios for property loans (LTV). In some regions, the LTV ratio has reached 50% (usually between 20% and 50%, depending on the region). Authorisation was also given to first-time buyers (or owners of a single property that will be sold during the transaction), to borrow with an LTV ratio of over 50% (compared to 0% up until now), if the price of the property is more than KRW 1.5 bn (USD 1.2 mn).

That said, this measure only affects a very small number of households, and regulation remains generally very strict, notably maintaining the LTV ratio at 0% for owners with multiple properties (in order to limit speculation). In addition, the rigorous macro-prudential policies implemented by successive governments in recent years have improved household debt structure and increased the proportion of borrowers with a high credit score . In Q4 2022, borrowers with high credit scores accounted for almost 78% of all borrowers.

In addition, the regulation on borrowers' capacity to repay their debt (Debt Service Ratio, DSR), implemented in 2018, was strengthened in July 2022, to include borrowings from all financial institutions (i.e., including loans from non-bank institutions). The authorised DSR has been capped at 50% (compared to 40%), and is applied to each borrower. In addition, a large proportion of mortgages and loans linked to the 'jeonse' (a particular type of lease common in the Korean market in which the tenant pays the landlord a very large sum of money whose investment remunerates the landlord) are backed by government institutions.

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SOUTH KOREA: HOUSEHOLD DEBT

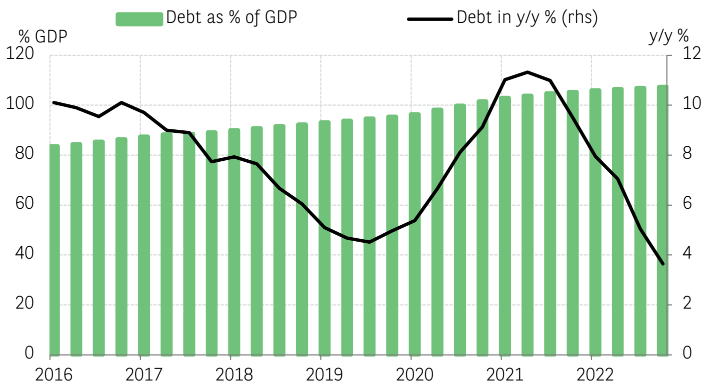

CHART 2

SOURCE: CENTRAL BANK