SOUTH KOREA

NEW CHALLENGES

South Korea's economic growth slowed throughout 2024, with limited prospects for a rebound. The political crisis and unprecedented government instability in the country are likely to result in a marked slowdown in domestic demand. The outlook for the export sector (mainly semiconductors) will depend in part on the trade policy adopted by the new US administration. South Korea is not directly targeted by tariff measures for the time being, but the resulting upheaval in value chains will adversely affect exports. Economic policy will remain accommodative: the Central Bank and the interim government have already proposed support measures, but the stimulus will not be enough to significantly boost growth, which is likely to continue to slow in 2025.

UNPRECEDENTED POLITICAL CRISIS

The political climate deteriorated sharply at the beginning of December, after President Yoon Suk Yeol briefly imposed martial law. Impeachment proceedings are under way and the President has been suspended pending the outcome of these proceedings. After several weeks of twists and turns, the President was finally arrested on 15 January and charged with insurrection on 25 January (one of the charges for which the President has no immunity). He will face a number of other charges, including treason, corruption and abuse of power. To date, there have been two interim presidents, and tensions are still high, with the opposition between the two "camps" (pro- and anti-president) leading to a number of confrontations.

This political sequence is not surprising, but its scale is unprecedented in South Korea. The polarisation of political life has accelerated in recent years, and a political crisis had in fact been brewing since the last legislative elections in April 2024. The (conservative) presidential coalition, led by the "People Power Party", won just 108 seats, while the opposition coalition, led by the "Democratic Party", took 170 seats. The combination of the President's very low popularity and the opposition majority in Parliament had already led to many government proposals being blocked.

However, the strength of Korean institutions remains undiminished. At the start of the crisis, the Central Bank announced that it was prepared to intervene if necessary to ensure the stability of the financial markets. At the same time, in the absence of a vote, Parliament has renewed the budget for 2024, and any additional expenditure will be examined on a case-by-case basis (the 2025 budget was under discussion in Parliament when martial law was attempted).

For the time being, the financial consequences remain limited. The initial pressure on the Won has partially subsided (at the end of January, the Won was still 2.5% weaker against the US dollar than at the beginning of December). In any case, South Korea's external vulnerability is limited, as foreign exchange reserves amount to around 7 months of imports and the country's net external position is in credit (and has been growing steadily for almost 15 years), which reduces its vulnerability to financial shocks and capital flight.

SLOWDOWN IN GROWTH

On the other hand, the impact on growth is likely to be more significant. Following average annual growth of 2.2% in 2024, growth is expected to fall to 1.6% in 2025. Growth has already slowed throughout 2024, standing at 1.2% y/y in the final quarter, with limited capacity for a rebound.

FORECASTS

	2022	2023	2024e	2025e	2026e
Real GDP growth (%)	2.6	1.4	2.2	1.6	1.9
Inflation, CPI, year average (%)	5.1	3.7	2.3	1.9	2.0
Gen. gov. balance / GDP (%)	-2.8	-1.5	-1.8	-1.7	-1.5
Gen. gov. debt / GDP (%)	49.8	53.6	54.1	54.9	55.3
Current account balance / GDP (%)	1.4	1.9	4.2	2.5	2.4
External debt / GDP (%)	40.0	34.9	31.8	31.0	29.5
Forex reserves (USD bn)	423	420	419	421	428
Forex reserves, in months of imports	6.2	6.6	6.8	6.6	6.4

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

SOUTH KOREA: LOWER INFLATION

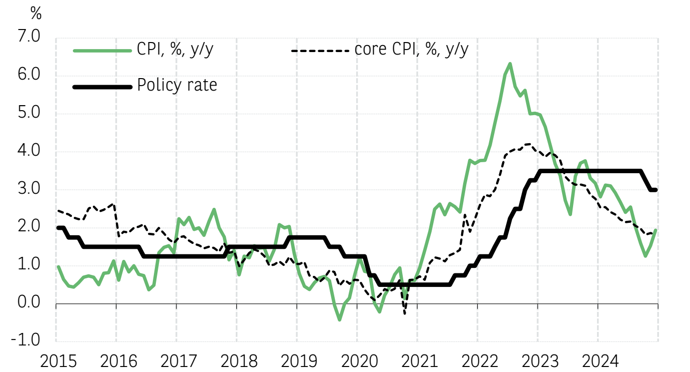

CHART 1 SOURCE: CENTRAL BANK, BNP PARIBAS

The political situation should lead to a slowdown in private consumption and investment. Indices measuring consumer and investor confidence fell in December. In the construction sector, investment has already slowed over the last three quarters. Meanwhile, the outlook for the export sector (mainly semiconductors) will depend in part on the trade policy of the new US administration. The policy mix is likely to remain accommodative, as measures to support growth will almost certainly be passed over the next few months (this is almost always the case in Korea during economic slowdowns), but the stimulus is unlikely to be enough to significantly boost growth.

SUPPORT FROM THE CENTRAL BANK

The Central Bank has indicated that it will look to support growth over the coming quarters. Given the political crisis and its potential financial repercussions, the key rate remained unchanged (at 3%) at the meeting on 16 January, but access to credit has been made easier for small and medium-sized businesses. The Central Bank's announcement suggests that several rate cuts are likely over the coming months. Despite the depreciation of the currency and fluctuations in commodity prices, inflation should remain contained (it came out at 1.9% y/y in December, after 1.5% in November). In addition, growth forecasts have just been revised downwards, as the Central Bank now expects real GDP growth of just 1.6-1.7% in 2025 (compared to 1.9% in the last forecasting exercise in November).

That said, Korean monetary policy is still constrained by the financial risks associated with high household debt (around 90% of GDP). The many macroprudential measures put in place have so far helped to contain these risks. Despite the desire of some committee members to "translate the drop in interest rates into household credit", the Financial Services Commission has indicated that it wants to contain the rise in debt to less than +3.8% (in real terms) in 2025.

NEW UPHEAVAL IN VALUE CHAINS?

South Korea is unlikely to be spared by the change in US economic policy. The situation is very different from the one during Trump's first term in office, since the structure of Korean foreign trade and integration into value chains has shifted in favour of the United States and away from China.

In 2024, 18.7% of total exports were to the United States (12% in 2017) and 19.5% to China (25% in 2017). Between 2017 and 2024, the trade surplus with the United States almost tripled, while the trade balance with China gradually moved from surplus to deficit (*see chart*). Last November, the US Treasury put Korea back on the list of "economies to watch", which could attract the attention of the Trump administration, even though no increase in tariffs has yet been announced. However, the bilateral US trade deficit with Korea (USD 55 billion in 2024) is still much lower than the one with China (around USD 300 billion). For the time being, Trump has not come out in favour of a potential renegotiation of the United States-Korea Free Trade Agreement (KORUS), as was the case during his first term in office.

A number of factors could work in Korea's favour: in 2023, the United States captured almost 45% of total Korean FDI (or USD 28 billion), well ahead of China (less than 3%, or USD 1.9 billion). The semiconductor sector is one of the main beneficiaries. In 2017, the United States received 33% of total Korean FDI in this sector, and China 7%. In addition, the value added of Korean exports is very high, and Korea is not on the list of "connector" countries used by China to circumvent US tariffs (countries whose exports contain relatively low local value added and high value added produced in China).

SOUTH KOREA: RISING COMMERCIAL SURPLUS WITH THE US

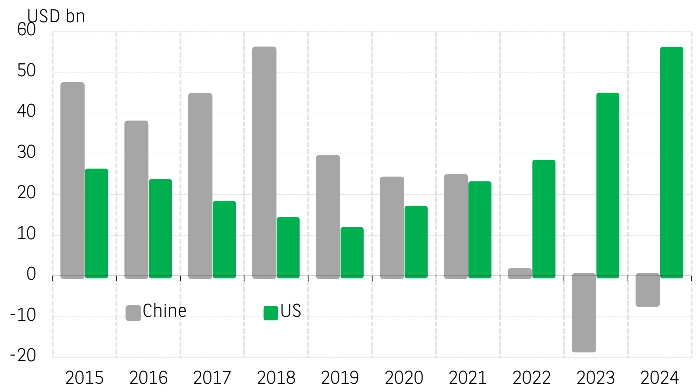

CHART 2 SOURCE: KOREA CUSTOM SERVICE, BNP PARIBAS

That said, even if there is no specific increase in tariffs, the Korean economy will be affected by US tariff increases on Chinese products. The Korean export sector would be indirectly affected. Potential Chinese retaliation could also have consequences, including competitive devaluation, which could destabilise Asian currencies, and tighter controls on Chinese exports, which could disrupt the region's value chains, in which Korea is highly integrated. In the short term, the support measures proposed by the government and the Central Bank would probably not be enough to offset the effects of the yuan's depreciation on Korean exports and growth, if the Chinese central bank were to pursue a strategy of competitive devaluation.

The implementation of long-planned structural reforms to boost industrial competitiveness is also threatened by the current political crisis. However, these reforms are crucial for the country's export sector, particularly against growing competition from China, the European Union and Japan, especially in the semiconductor sector.

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