# SOUTH KOREA



## A COMPLEX ECONOMY

**The third wave of the Covid-19 pandemic is unlikely to jeopardise the dynamic momentum of South Korea's economic recovery. Solid fundamentals, diversified exports and massive fiscal and monetary support should help limit the impact of the crisis on the country's medium and long term growth prospects. In contrast, an ageing population continues to erode the country's growth potential and public finances, even though the government has implemented a series of structural reforms. Household debt has picked up rapidly over the past 18 months. The associated credit risks are limited, however, thanks to the implementation of macroprudential measures and the comfortable level of household financial assets.**

### "LIVING WITH COVID-19"

Unlike the majority of countries in the region, the resurgence of the Covid-19 pandemic at the end of Q2 2021 did not undermine the economic rebound. The Google mobility index rose to an all-time high in mid-September (after easing briefly at the end of August), despite the relatively high number of new Covid-19 cases. The elderly and the most vulnerable populations have already been vaccinated, and the number of Covid-related deaths was relatively low during the third wave of the pandemic.

The government also announced that it would rapidly abandon its *"zero Covid"* strategy with its draconian health restrictions starting in late October, and would instead adopt a series of measures that aim to *"live with Covid-19"*. The goal is to return to *"normal life"* by gradually lifting the restrictions in place. The government has also set a target of fully vaccinating (two doses) 80% of the total population by the end of the year. At 4 October, nearly 80% of the population had received at least one dose, and 55% had received two doses.

The recovery continued in H2 2021. The rebound in domestic demand was only marginally affected by the recent spike in cases. At the same time, the labour market continued to strengthen. The unemployment rate has declined continuously since early 2021, from 6% in January to 2.4% in August. New consumer support measures announced in early September (for a total of nearly 0.5% of GDP) are also expected to boost household consumption.

External demand is also going strong. Exports have rebounded vigorously since Q3 2020 as South Korea benefited from strong demand for electronic goods arising from the development of working remotely. This strong export performance carried over to investment, notably in the telecom sector, such as infrastructure projects for the development of 5G networks. In real terms, investment increased at an average rate of nearly 4% y/y in H1 2021, compared to a long-term average of just over 3% (2015-2019).

Yet exports should slow in the last three months of the year as momentum erodes due not only to base effects, but also to supply-side constraints and the laborious start-up of supply chains. Supply constraints can be found in all sectors, especially the automobile sector, which was hard hit by the shutdown of a semi-conductor plant in Malaysia due to tighter health restrictions introduced following a new wave of the pandemic.

After a very mild recession in 2020 (GDP contracted 0.9%), thanks to effective pandemic management and massive fiscal and monetary support, GDP growth is expected to reach 3.9% and 3%, respectively, in 2021 and 2022.

FORECASTS

| | 2019 | 2020 | 2021e | 2022e |
|---|---|---|---|---|
| Real GDP growth (%) | 1.8 | -0.9 | 3.9 | 3.0 |
| Inflation, CPI, year average (%) | 0.4 | 0.4 | 2.1 | 1.7 |
| Gen. gov. balance / GDP (%) | -0.6 | -5.8 | -4.0 | -3.2 |
| Gen. gov. debt / GDP (%) | 39.5 | 44.0 | 48.2 | 52.1 |
| Current account balance / GDP (%) | 3.6 | 4.6 | 4.4 | 4.0 |
| External debt / GDP (%) | 28.4 | 30.1 | 30.4 | 29.2 |
| Forex reserves (USD bn) | 404 | 408 | 443 | 481 |
| Forex reserves, in months of imports | 7.5 | 7.5 | 7.3 | 7.8 |

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

EXPORT REBOUND

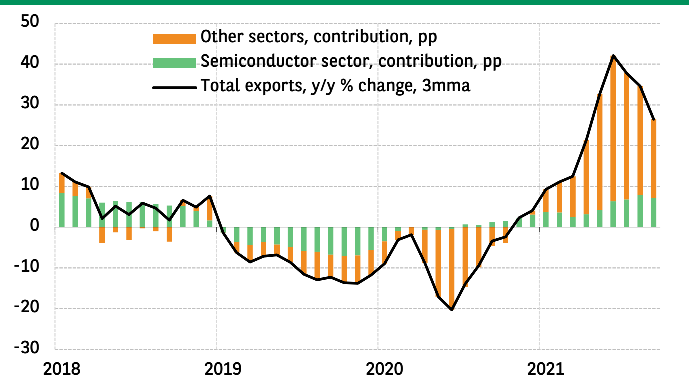


CHART 1

SOURCE: MINISTRY OF TRADE

The Covid-19 crisis should continue to have a very limited impact on South Korea, thanks not only to the authorities' massive support measures, but also to the economy's capacity to absorb shocks. This is facilitated by the economy's complexity, i.e., the diversity of export sectors and the intensity of knowledge and skills used to produce these goods. According to Harvard University's Atlas of Economic Complexity, South Korea's economy ranks fourth in terms of complexity (out of a selection of 133 countries), behind Japan, Switzerland and Germany.

In contrast, medium-term growth prospects continue to deteriorate due to an ageing population. A recent IMF study revised downwards its estimate of South Korea's growth potential to 2%, from 2.5% previously, due to the impact of the decline in the active population (15-64 age group) and the expected acceleration of this decline over the next decade. In the study, the authors even took into account the government's proposed reforms to improve productivity gains, notably the "Korean New Deal" with its three Green, Digital, and Human pillars, which aim to facilitate public and private investment.

## FISCAL POLICY WILL REMAIN ACCOMMODATING IN 2022

The public deficit (excluding the social security fund) swelled rapidly in 2020, to 5.8% of GDP (compared to an average of 1.6% between 2015 and 2019). The government used its fiscal manoeuvring room to launch economic support measures, and four waves of stimulus measures were announced over the course of the year, for a total of nearly 3% of GDP.

The same policy was applied in 2021. In March, July and September, the government announced three series of measures that aim to boost domestic demand by targeting the most vulnerable households as well as SMEs. It is also counting on the smooth rollout of its vaccination campaign. Thanks to strong growth of fiscal revenues, South Korea should nonetheless manage to reduce the deficit to 4% of GDP in 2021.

In its 2022 budget proposal presented in September, the government announced that it would maintain an expansionist fiscal policy in 2022, with spending set to increase again by more than 8%, before gradually consolidating public finances as of 2023. Even so, revenue growth is expected to be strong enough to significantly reduce the deficit, to 3.2% of GDP as of 2022.

The government also plans to gradually slow the pace of spending increases (to an average of 5.5% a year by 2025) and to stabilise the deficit at between 2.5% and 3% of GDP over the same horizon.

Under this environment, the public debt would swell continuously, from 48.2% of GDP in 2021 to nearly 58% in 2025. Yet the increase in debt does not present a risk in the short to medium term.

The results of the presidential elections scheduled for March 2022 are unlikely to call into question these assumptions, since all of the candidates have pledged to consolidate the country's public finances.

## HOUSEHOLD DEBT HITS A RECORD HIGH

Inversely, monetary policy has already begun to return to normal. The central bank raised its key rate to 0.75% in August, after leaving it at an all-time low of 0.5% since May 2020. Inflation is expected to level off at an average of about 1.7% in 2022, after peaking at 2.1% in 2021. In addition to the strong cyclical recovery, the central bank's press release points out the growing risks to financial stability.

A small supply of houses and exceptionally low interest rates drove up real-estate prices. At the national level, the house price index has increased by more than 15% since the beginning of 2021, and by more than 25% since mid-2020. Naturally, household debt rose sharply over the same period: it amounted to nearly 110% of GDP at the end of Q1 2021, up from 94.1% in Q4 2019. Debt outstanding rose 12% over the period.

HOUSEHOLD DEBT

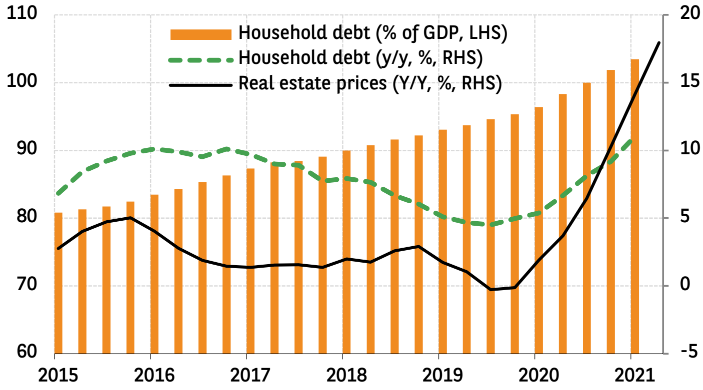


CHART 2 SOURCE: CENTRAL BANK

In the short term, the credit risk associated with household debt seems to be mild. On the one hand, the banking sector as a whole is relatively solid, and on the other, according to the central bank's most recent financial stability report, the amount of household assets is still twice as high as the amount of household debt. Moreover, macroprudential measures that were regularly implemented since 2017 have steadily reduced the number of loans to the most vulnerable households, i.e., those with limited capacity to repay their debt. At the end of Q1 2021, the amount of loans outstanding with vulnerable households accounted for only 5% of total loans outstanding (down from nearly 7% in 2017). Lastly, the government and the central bank recently announced new macroprudential measures.

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