COFACE BRIEF

30 JULY 2019 – CARLOS CASANOVA & TIANYU PANG

CONFIDENTIAL

South Korea: better growth due to higher public spending is not enough to offset headwinds

GDP forecast 2019: 2.2%; 2020: 2.5%
Coface Country Risk Assessment: A2 (low)

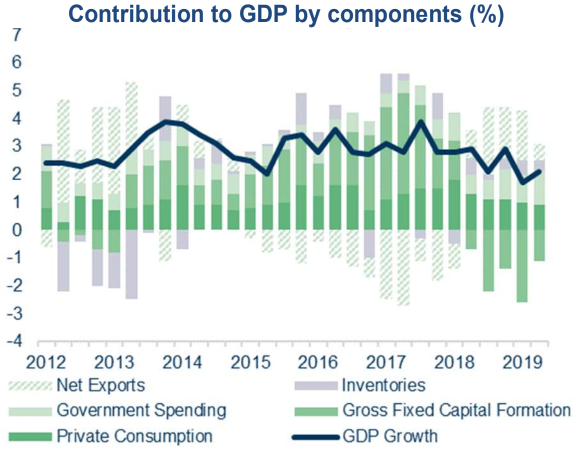
What

South Korea's GDP expanded by 2.1% YOY in the second quarter of 2019, according to provisional data by the Bank of Korea (BOK), up from a 1.7% increase in Q1. **The economy rebounded by 1.1% quarter-on-quarter in Q2, improving from a -0.4% QOQ contraction in Q1 and avoiding a technical recession.** Nevertheless, despite better-than-expected Q2 GDP figures, the economy is still facing both internal and external headwinds. **Most of the upside to growth came on the back of fiscal stimulus.** In response to anaemic activity on the private side, **Bank of Korea (BOK) cut its benchmark interest rate by 25 basis points to 1.50% on July 18**, **while simultaneously trimming its growth and inflation forecasts for 2019** to 2.2% (down from 2.5%) and 0.7% (vs. 1.1%) respectively. We expect growth to rebound slightly, averaging 2.2% YOY in 2019 thanks to government stimulus. However, risks are tilted to the downside.

Why

1) **The South Korean economy is heavily reliant on exports** (45% of GDP), notably semiconductors, smartphones, automobiles, and ships. **Weak external demand, exacerbated by the US-China trade war and a global downturn in semiconductor prices, has contributed to the slowdown of South Korea's economy**, with exports contracting -9.2% YOY in the first half of 2019. Exports to China (nearly 25% of total exports) contracted -16.9% YOY in H1, and exports of semiconductors (nearly 20% of total exports) plummeted -22.5% YOY in H1. To make matters worse, on July 1, **Japan imposed export restrictions on key components used in the manufacture of semiconductors and electronic displays**, as retaliation to a South Korea ruling requiring that Japan pay compensation for the deployment of Korean wartime labourers. This has incurred delays of up to three months, aggravating supply chain disruptions and further hurting the critical electronics subsector.
2) **Private consumption remains sluggish despite better headline figures.** Imports declined by an average of -5.5% YOY in H1, while department store sales remained flat during the same period, averaging 0.8% YOY. **Household purchasing power continues to be impaired by very high levels of household debt, equivalent to 97.7% of GDP in 2018, according to the BOK.** Most of this debt is tied to mortgages, so higher costs of debt service following BOK's November 2018 hike and a decline in home prices have dampened consumer sentiment, with BOK's index reaching a 2-year low in June 2019. The 11% minimum wage increase, effective since January 2019 and expected to address these concerns, led to pressure for unskilled workers.
3) **The South Korean economy is also suffering from weak domestic investment,** with gross fixed capital formation (GFCF) dropping -3.6% YOY in Q2 after plunging by -8.6% in Q1.The negative contribution of GFCF started in mid-2018. On the industrial side, capital expenditure has been most muted in the electronics and materials segments. However, the automotive sector is also expected to struggle owing to weak motor vehicle sales (1% YOY in H1), despite a moderate uptick in exports of SUVs and "eco-friendly" vehicles in Q2.

Contribution to GDP by components (%)



Sources: Bloomberg and Coface

4) **Government spending increased 7.3% YOY, contributing more than half of GDP's expansion in Q2.** South Korea's parliament approved a record 469.6 trillion won (USD 417.6 billion) budget for 2019, a 9.5% increase from 2018. Nevertheless, this unprecedented contribution of government spending can be largely traced back to the delayed implementation of government grants and subsidies offered to municipal governments in Q1. **Government spending will likely contribute less in H2, unless more aggressive fiscal stimuli are announced**. Public debt levels remain relatively low (below 40% of GDP) and steady budget surpluses in previous years means there is still room for a more expansionary policy stance. A supplementary budget worth 6.7 trillion won (USD 5.87 billion) was proposed by the government on April 24, but is still pending approval by Parliament due to political impasse.

Risks

1) **Monetary policy to become more expansionary:** According to BOK forecasts, the economy would have entered a technical recession without additional government spending. However, it's unlikely that the supplementary budget will be adopted quickly given the current impasse. Monetary policy will have to become more accommodative to support private investment and avoid missing growth expectations in H2. We expect at least one more cut to 1.25 bps and further depreciation of the South Korean won in 2019.
2) **Trade spat with Japan:** The ban could be significantly more disruptive than slower demand from China in the short-term. Japan accounts for approximately 90% of South Korean imports of these components, so the potential for disruption on global electronic supply chains is huge. Japan's economy faces similar pressures on the external front, so it seems likely that both parties will reach a resolution before the end of the year.
3) **Weaker growth:** Given uncertainties surrounding downside risks to growth, an even weaker 2019 growth rate is possible. Our current forecasts (see header) are in line with BOK's recently revised figures.