British Embassy
Seoul

## The challenge of Choinomics

- **Choinomics has had little impact. The GDP growth rate fell further to 3.2% yoy in Q3 from 3.5% yoy in Q2 of this year.**

- **A slowdown in investment and exports is the main reason. Facility investment decreased 0.8%, while Korea's exports declined 2.6% qoq in Q3.**

- **Domestic demand, however, is showing signs of a rebound, prompted by improvements in the labour market, loosening of mortgage financing, as well as another interest rate cut in October.**

- **Key still concerns are around slowing global demand for Korea's exports and rising household debt. An additional concern is the ever-weakening Japanese Yen.**

## Can a weaker Yen threaten the Korean economy?

- **A weak Japanese Yen directly affects the Korean economy by hampering the price competitiveness of Korea's exporters against Japanese counterparts.**

- **So far, a weaker Yen has only had a limited impact on the Korean economy. However, with further QE in Japan, it is likely that the Won-Yen gap will be prolonged. The markets are already reacting to the risk that this entails.**

- **Increased competitiveness from Japan is most likely to occur in the steel, petrochemical and machinery sectors.**

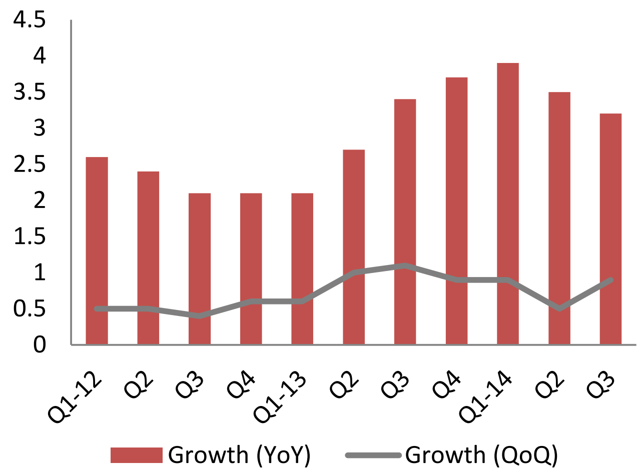
- **Korean conglomerates are reacting, with some taking advantage of the situation and switching to cheaper supply chain components from Japan. However, Korean SME's are likely to be hardest hit.**

## The challenge of Choinomics

**Choinomics, the term given to Finance Minister Choi's recent stimulus policies to avert economic slowdown, has had little impact.** The economy slowed further in the third quarter, with the growth rate falling to 3.2% yoy (0.9% qoq) from 3.5% yoy (0.5% qoq) in the second quarter of this year.

**Accordingly, the OECD revised down its 2014 growth forecast for the Korean economy to 3.5% from May's forecast of 4%.** The OECD also cut its 2015 growth forecast for Korea to 3.8% from 4.2%.

<Graph 1> GDP Growth Rate (Bank of Korea)




**The main causes of the slowdown were drops in investment and exports.** Facility investment decreased 0.8%, while Korea's exports declined 2.6% qoq in Q3, with exports to Europe, Japan and other emerging countries seeing the greatest reduction. Korean industrial production has been affected by the sluggish exports. In particular, electronics and petrochemical sectors are struggling as a result of a slowdown in demand from China and competition from a weakening Japanese Yen.

**However, domestic demand is showing signs of a rebound**, prompted by improvements in the labour market and the government's stimulus efforts. Along with these, lower interest rates have helped consumption recovery.

**The Bank of Korea (BoK) lowered its benchmark interest rate by 25 basis points to 2.0% in October in response to the lack of growth momentum.** This was the second rate cut in three months. However, the recent rate cuts are expected to reduce foreign investment in the Korean financial market. The cuts have also been criticised for rising further household debt, potentially Korea's greatest macroeconomic risk. Household debt had already reached KRW 1,040 trillion (USD 994 billion) in the second quarter of 2014, up from KRW 1,025 trillion (USD 920 billion) in the first quarter.  In October, growth in the number of bank loans to households picked up strongly to 7% yoy, due to loosening of mortgage financing regulations and the BoK's policy rate cuts in August and October.

**In addition to concerns about global demand for exports and rising household debt, there are renewed concerns about the strong Korean Won against an ever-weakening Japanese Yen.** On 4 November, the Korean won closed at 951.73 won against 100 Japanese Yen, a change of 11.87 Won from the previous day and the Won's strongest level since 2008. The primary cause was the sharp drop in the Yen, following the Bank of Japan's announcement that it would embark on further rounds of quantities easing (QE) to help lift the flagging Japanese economy.

## Can a weaker Yen threaten the Korean economy?

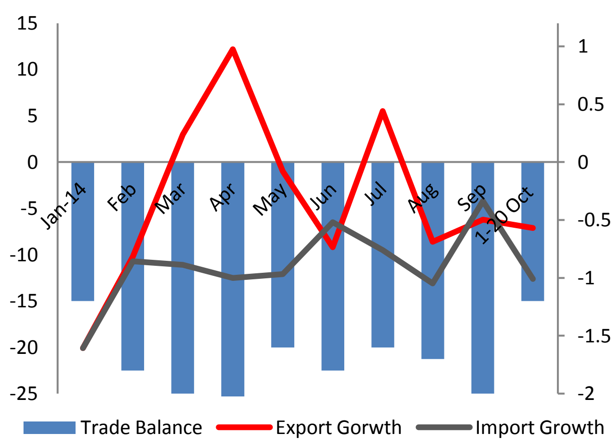
**A weak Japanese Yen directly affects the Korean economy by hampering the price competitiveness of Korea's exporters against Japanese counterparts.** Around half of Korea's top 100 export products compete directly in the global market with similar exports from Japan.

**So far, a weaker Japanese Yen against the Korean Won has only had a limited impact on the Korean economy.** This is partly because of the strength of Korea's brand and the reputation it has for reliable and high quality exports, but also because Japanese brands have so far resisted cutting their global prices.

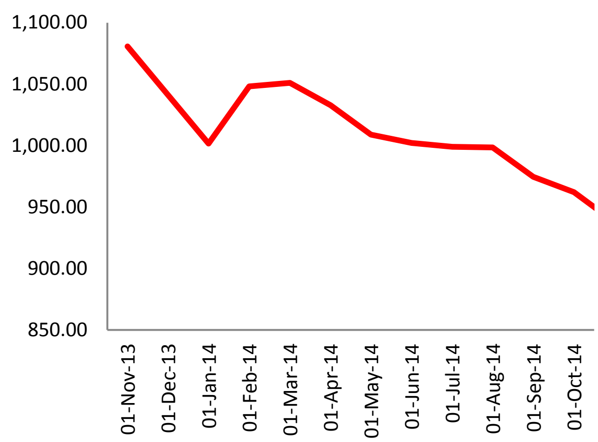
**However, with further QE in Japan, it is likely that the Won-Yen gap will remain for a much longer period,** and could even widen further, giving time for Japanese products to gain an edge on Korean competitors. This would weigh heavily on the Korean economy's recovery, on top of already slowing export momentum due to weak global demand.

One private think-tank estimated if the Won-Yen exchange rate falls to around 1,000 won per 100 Yen, Korea's exports to Japan will likely decrease 7.5% and down to 9.1%, if the exchange rate falls to 950 compared to the 2013 average rate of 1,123.8 Won per 100 yen.

<Graph 2> Export, Import & Trade Balance with Japan (MOTIE)




<Graph 3> Won-Yen Exchange Rates (against 100Yen) (BOK)




**The Korean companies which are most likely to see increased competitiveness from Japan are in the steel, petrochemical and machinery sectors.** Analysts estimate that Korean exports from these sectors to the global market drop by 1.31%, 1.13% and 0.94% respectively when the Won-Yen exchange rate falls by 1%.

**Movement in the markets reflects the concern:** Shares of Korea's car-makers Hyundai and Kia fell 5.9% and 5.6% respectively on 3 November, as their price competitiveness against Japanese car-makers was put into question following the sharp fall in the Yen against the Won. On 4 November, the benchmark Korea exchange, KOSPI, which comprises the shares of Korea's major companies took a hit, closing at 1,935.19, down 0.1%.

**Korean industry is reacting quickly to minimise its impact on their business.** Hyundai Motors is expanding their overseas productions. Conglomerates, including Samsung Electronics are taking advantage of the weak Yen by increasing imports of components from Japan.

**The greatest impact, however, is on Korean SMEs,** which have little opportunity to adapt. Many Korean SMEs exporting directly into Japanese supply chains have been particularly hard-hit. According to the Korean Federation of SMEs, the break-even point for SME exports to Japan is 1,040 per 100 Yen. So the current rate of about 950 Won per 100 Yen, is very challenging, and represents a 40% decrease in export revenues since 2011 when the Yen was trading at more than 1,500 Won per 100 Yen. Furthermore, some Korean SMEs are being squeezed out of Korean, and indeed global, supply chains as large companies switch to more competitive components from Japan. This ultimately makes the Korean government's goal of diversifying wealth away from conglomerates all the more challenging.