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Korea Economic Focus

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Growth forecasts lowered as GDP growth slows

- The Bank of Korea recently lowered its 2014 growth outlook from 4% to 3.8%, while the Ministry of Strategy and Finance reduced its forecast from 3.9% to 3.7%, both concerned about global demand and sluggish domestic consumption

- Real GDP growth in Q2 decelerated to 3.6% yoy (0.6% qoq) from 3.9% yoy in Q1.

New Finance Minister announces economic stimulus package

- Newly appointed Deputy Prime Minister Choi, Kyung-Hwan vowed to lift the flagging economy with a USD 40 billion stimulus package. He announced measures to:
  - raise household income by introducing corporate tax incentives that encourage businesses to spend cash reserves on wages, dividends and jobs; and to
  - support the housing market by easing regulations on mortgage financing.

- Analysts concerned that corporations will only spend more if the tax benefits outweigh the costs, and that measures to ease mortgage lending could fuel further household debt.

Korea's exports continue to drive growth

- Exports in July rose by 5.7%, up from a 2.5% increase in June, despite a slowdown in the Chinese economy as demand from countries in Southeast Asia, EU and US picked up.

China's leader visits Korea

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- Chinese and Korean leaders committed to completing bilateral FTA by the end of 2014, and to establish a Korean Won - Chinese Yuan exchange market.

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Korea's 2014 growth forecasts lowered as GDP growth slows

The Bank of Korea recently lowered its 2014 growth outlook from 4% to 3.8%, while the Ministry of Strategy and Finance reduced its forecast from 3.9% to 3.7%. Both organisations cited growing downside risks, including concerns about global demand and sluggish domestic consumption. Real GDP growth in Q2 decelerated to 3.6% yoy (0.6% qoq) from 3.9% yoy in Q1.

The Bank of Korea (BOK) left interest rates unchanged at 2.5% in July. However, many experts expect the BOK to cut its rate by 25bp to 2.25% in August to support the government's recently announced stimulus measures (see below).

Chart 1: GDP Growth (Bank of Korea)

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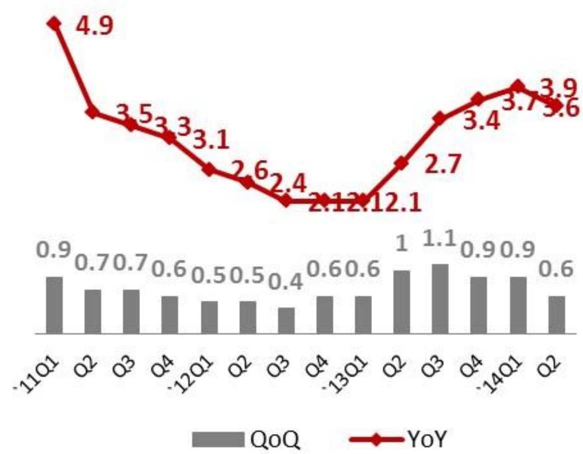

New Finance Minister announces USD 40 billion economic stimulus package

The newly appointed Deputy Prime Minister, and Finance Minister, Choi Kyung-Hwan vowed to revive the flagging economy. On 24 July the government's new economic team set out a fiscal and financial stimulus package worth KRW 41 trillion (USD 40 billion, 3% of GDP). KRW 11.7 trillion will come from government funds and KRW 29 trillion from state-owned financial institutions and the Bank of Korea. The government said the measures will focus on:

- Raising household income by introducing corporate tax incentives that encourage businesses to spend cash reserves on wages, dividends and jobs.

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Choi noted that companies' depressed investment levels were preventing households' income growth which in turn has led to weak private consumption.

- **Supporting the housing market by easing regulations on mortgage financing.** DPM Choi considers private consumption growth to be largely constrained by the sluggish property market as well as high household debts. Ceilings for LTV (Loan-to-Value) and DTI (Debt-to-Income) ratios will be raised to 70% and 60% respectively across the country. Current ceilings of 50% in the Seoul area have been in place since the last property boom.

News of the stimulus package sent the KOSPI, Korea's main stock exchange, to a new eight-month high. However, many analysts and industry groups are sceptical about the measures' impact. They argue that corporations will only be encouraged to spend more if the tax benefits outweigh the costs, and measures to spur the housing market could ultimately fuel further household debt.

Household debt: Korea's Achilles' heel

As President Park stated at the start of the year, the Korean economy needs to rebalance its dependence on exports towards increased domestic consumption. However, high household debt remains a key barrier and has been the Korean economy's Achilles' heel in recent years. The Bank of Korea (BOK) said that the total level of household debt rose to a new record level of USD 1 trillion as of the end of March 2014. The sluggish property market, along with rising housing lease (Jeonse) prices, are considered to be key contributing factors to the rising debt.

DPM Choi, however, considers current policies aimed at limiting household debt are the root cause of weak domestic demand. The government's move to relax mortgage lending is therefore aimed at boosting the economy by reinvigorating the housing market. Experts believe the policy could be beneficial to some: the

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better terms offered by banks could encourage homeowners who bought their homes with higher interest loans from non-bank financial institutions to transfer to more manageable longer-term bank borrowing.

However, many analysts are concerned that Korea’s household debt to disposable income ratio already exceeds 160%, much higher than other advanced economies. Further interest rate cuts and greater access to mortgages could increase household debt further. If so, this would only serve to inhibit domestic consumption. Instead, economic commentators would prefer to see a renewed focus on the structural reforms, including regulatory and labour market reforms, which were announced under the Three Year Economic Plan earlier this year.

Korea’s exports continue to drive growth

Exports are faring better than expected despite a slowdown in the Chinese economy as demand from countries in Southeast Asia, EU and US has picked up. Exports in July rose by 5.7%, up from a 2.5% increase in June, helping to support Q2 GDP.

Korea’s trade account posted a USD 2.5 billion surplus in July, marking the 30th consecutive month in surplus, due to an increase in demand from advanced countries including the US and EU.

However, exports to China, Korea’s largest trading partner, declined for the third consecutive month, with a drop of 7% in July.

Chart 2: Exports and real GDP (Nomura)

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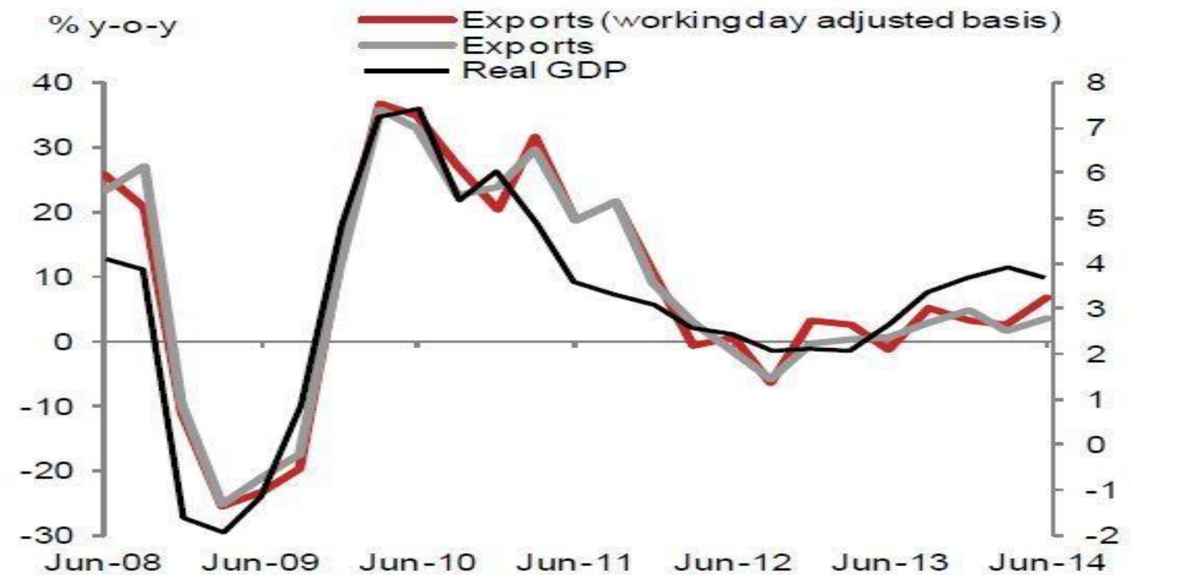

Note: Q2 2014 is Nomura forecast.
Source: CEIC and Nomura Global Economics.

China's leader visits Korea

Xi Jingping's visit to Korea on 3 July focussed on raising economic cooperation between the two countries. Main outcomes of his visit were:

- **Completion of the China-Korea FTA negotiations:** the two leaders expressed their commitment to finalise the bilateral trade agreement within this year. The 12th round of FTA talks were also held in Korea in July.

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- **Establishment of a Korean won and Chinese Yuan exchange market:** The leaders agreed to open a won-yuan currency market in Korea. The direct won-yuan currency market will save Korean and Chinese corporations engaged in direct trading, by removing the need to use dollars as an intermediary currency in won-yuan transactions, thereby cutting currency conversion costs and risks.

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