

Korea likely to see modest recovery through rest of year

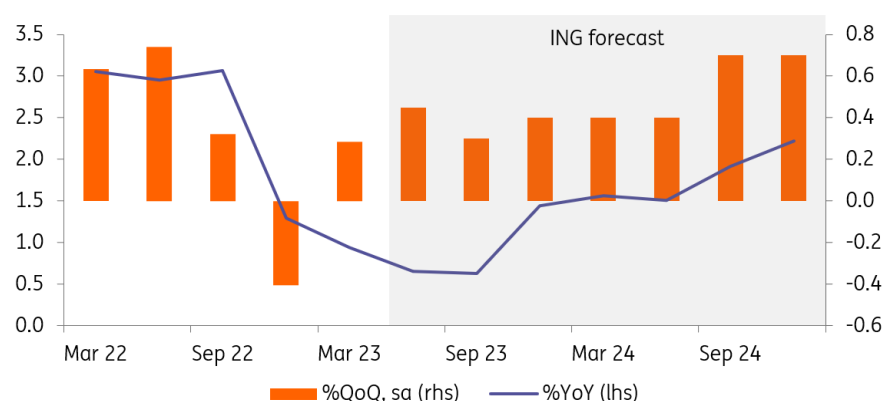
We believe that Korea's economy bottomed out in the fourth quarter of last year. However, the recovery will be quite shallow going forward, so GDP growth will remain below potential levels



Expect stronger second quarter growth

Monthly activity and other high-frequency data suggest second quarter GDP accelerated to 0.5% quarter-on-quarter seasonally-adjusted, from 0.3% in the first quarter, as the contribution of net exports and investments improved, while private consumption ran out of steam. Beyond the second quarter, terms of trade are better but domestic demand is expected to soften on the back of tight monetary and fiscal conditions. We expect annual GDP growth to rise by 0.9% year-on-year in 2023 compared to 2.6% in 2022.

Below potential growth to continue in 2H23



We agree that final demand from the US and EU is expected to weaken dramatically in the second half of 2023, and China's reopening will not provide meaningful stimulus to the global economy. Manufacturing PMI readings are currently in the contraction zone of less than 50 in many major economies, including the EU and Japan. Therefore, global demand conditions will not be favourable for Korea's exports to fully recover.

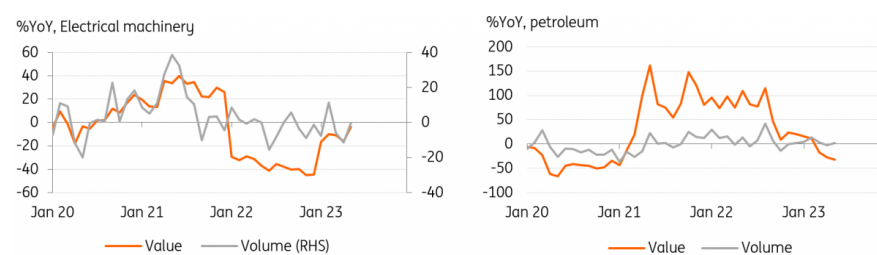
Nevertheless, we believe Korean exports will continue to improve. Why? We explain it below.

Trade conditions will improve due to soft commodity prices

Given the already poor performance of the first half of 2023, annual export growth will likely shrink. But we think export growth has already bottomed out and the contraction will ease in the third quarter and eventually turn positive in the fourth. Although the trade balance turned to a surplus in June for the first time in 16 months, it was mainly due to a sharp decline in commodity imports, rather than export recovery. The trade balance is expected to remain in surplus for most of the second half of the year, as the impact of import declines will accelerate with rapidly falling global commodity prices.

The sluggish export performance is mainly driven by the fall in semiconductors and petroleum. Unfavourable price effects dominated the poor performance of these two major export items. Looking at the exports in volume terms, the decline was modest compared to those in value terms. We believe that negative price effects will fade out gradually during the remainder of the year.

Exports in value terms declined sharply due to unfavourable price effects



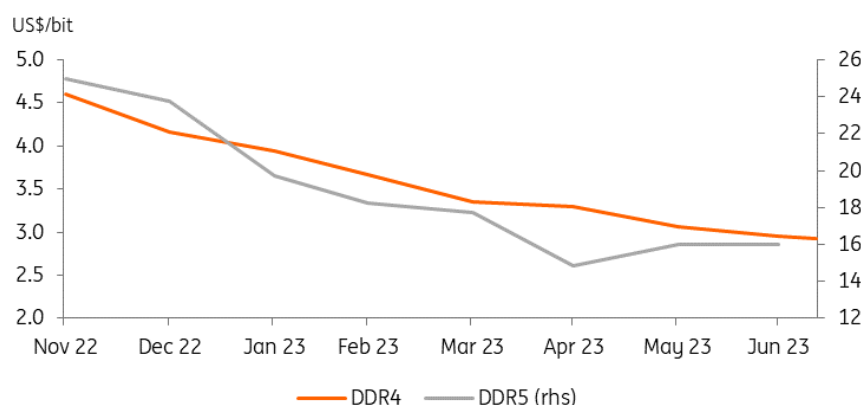
Unfavourable price effects will likely ease by the end of this year

According to the latest market data, the general-purpose DRAM prices (DDR4) continued to slide in July, but high-value, high-performance next-generation product prices have rebounded slightly since April. We think that the downward cycle in semiconductors is slowly bottoming out around high-end products, but high-end lines are still a minor segment of the DRAM market. Thus, overall DRAM prices are expected to weaken in the third quarter as the oversupply continues.

May industrial production data showed that semiconductor production rose despite the commitment of output cuts from two major chipmakers, thus inventories also gained slightly. Sector analysts estimated that Samsung Electronics and SK Hynix would reduce their output by about 5-10% each, but expected it to take three to six months for meaningful production cuts to take place. So, we expect a slowdown in chip manufacturing, accounting for about 20% of total industrial production, which is one of the reasons for slowing third-quarter GDP. At the same time, however, inventory adjustment is another reason why we believe that DRAM prices may rebound at the end of the year.

In addition, Korean chipmakers will benefit the most from AI chips such as HBM (High Bandwidth Memory) on the back of recent advances in AI technology. Even if the US economy tips into a recession at the end of this year, investment in IT and new technologies will likely remain robust, therefore we believe that high-value chip and related machinery exports will improve, regardless of the US business cycle. We expect the recovery of chip exports to be extended into next year.

High-valued DRAM prices appear to have bottomed out



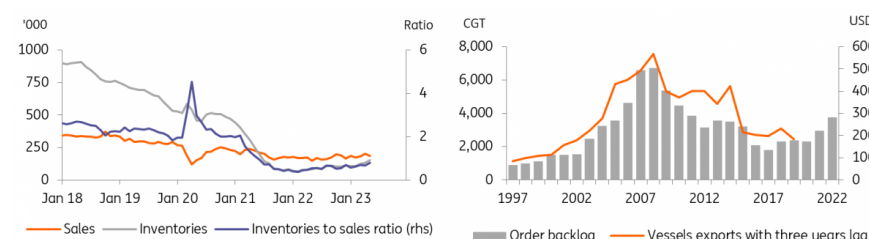
Source: DRAM exchange

Transportation exports will drive export growth this year

In the automobile industry, global supply chain disruptions have improved, while the catch-up demand hasn't yet been fully met, leading to robust vehicle exports. We had been concerned that the combination of high borrowing costs with IRA acts (tax incentives available only to US car manufacturers) would eventually reduce demand for Korean vehicles. However, given the tight inventory conditions and strong demand for electric vehicles, vehicle exports should remain strong. While auto sales will cool in the second half of 2023, the current inventory level is too low so inventory accumulation should persist for a while.

Meanwhile, vessel exports are expected to improve further but with high monthly volatility. Pre-ordered vessels during the pandemic are now ready to complete. The backlog of orders has a strong positive correlation with vessel exports with a three-year time difference. Although vessel exports do not reflect the current global business cycle, they can serve as a countercyclical buffer for Korean exports for the next two years or so.

Transportation exports will drive export growth in 2023

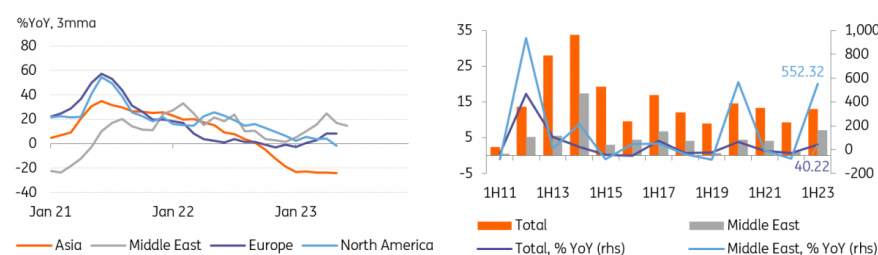


Source: CEIC, KOSTAT, KITA

Investment boom in the Middle East will also support exports

Over the past six months, exports to the Middle East have increased sharply compared to other regions and are expected to accelerate further in the near future. According to the Ministry of Trade, Industry and Energy, Korea's overseas plant orders jumped 40.2% YoY in the first half of the year, mainly led by petrochemical facilities from the Middle East (Saudi Arabia and Qatar). Since Korean engineering companies usually include plant equipment orders as part of their project deals, exports of machinery and materials are expected to benefit from plant orders.

Exports to Middle East will continue to outperform



Source: CEIC, MoTIE

Forward-looking data suggests domestic demand will soften

Although exports will serve as a driving force for the recovery over the rest of 2023, we believe weakening domestic demand will be a major drag. Investment is expected to remain the weakest part. Machinery orders and capital goods imports, both leading indicators of facility investment, have remained in contractionary territory for more than six months, indicating that the current contraction will last about a quarter more at least.

Despite the slump in the real estate market that began in early 2022, construction contributed positively to growth until the first half of this year, as ongoing construction projects have been completed over the last year. However, the negative impact of the reduction in orders, permits, and construction starts will finally be reflected in GDP from the second half onwards. Rising unsold units will also likely weigh on construction activity for a considerable time.

Another concern is the slowdown in service activity. Since early 2022, the reopening effect has solidly boosted service activity and led GDP growth, but service activity has declined for the last three consecutive months. We think that the reopening effect is fading as fiscal policy support runs out and borrowing costs rise. This is also reflected in retail sales, where sales growth is gradually slowing.

Investment will remain the weakest part of the economy



Fiscal support will be limited with a shortfall in tax revenue

Korea's debt-to-GDP ratio increased quite considerably during the pandemic period, and the fast pace of debt growth has become one of the government's main concerns. Therefore, the government committed to improving its fiscal health. Meanwhile, from January to May, tax revenues fell KRW 36.4 trillion compared to the previous year, mainly due to the slump in the real estate market. Given the strong will to improve fiscal soundness and the lack of tax revenues, we believe that the government will likely restructure its spending by eliminating earmarked projects that are not a priority. Thus, we believe that tight fiscal measures will not provide much support to growth in the second half of the year.

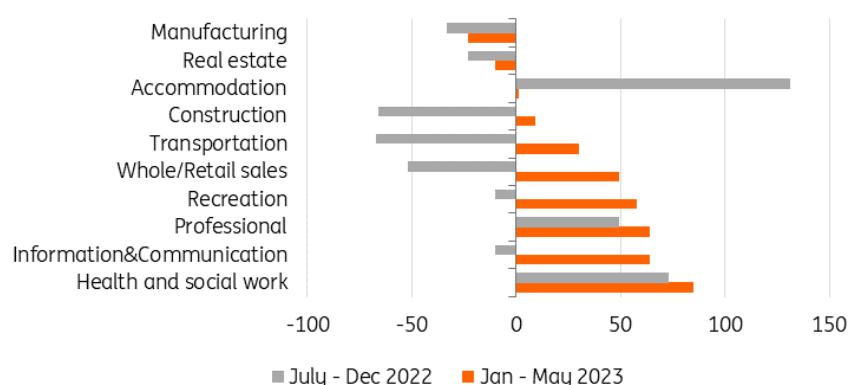
Labour market data illustrates growth of each sector

The manufacturing and real estate sectors are two major industries that have been consistently cutting jobs since July 2022, while construction employment has remained lacklustre, echoing the contraction in manufacturing and construction growth. Service jobs have been generally solid, but fluctuations by sub-industry are noticeable.

First, despite the normalisation of Covid-related policies, health and social welfare has steadily increased jobs. Second, the number of hospitality and leisure-related jobs has risen significantly. Last year, accommodation and restaurants added the most jobs, and this year, other services such as recreation, transportation, and whole/retail sales have gained substantial ground.

In line with this trend, household consumption of goods and services has remained robust so far. But we look for a moderation of job gains in private services in the near future as household consumption is expected to weaken mainly due to deteriorating financial conditions. It is noteworthy that in recent months there has been a strong increase in ICT and professional jobs that are thought to be related to software/platform development, including AI technology. We think manufacturing IT is likely to remain sluggish in the near term, but software IT will continue to grow solidly. This will likely be translated into strong research and development investment.

Jobs shed in manufacturing and real estate sectors

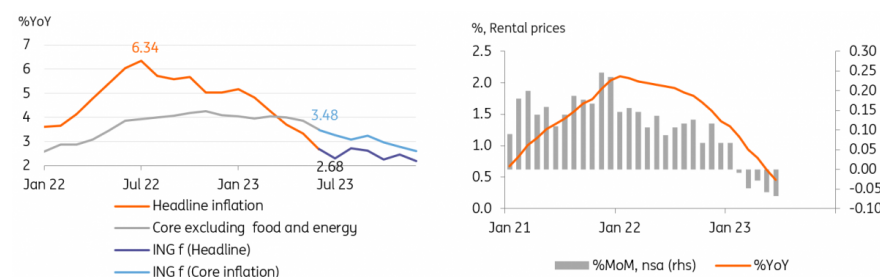


Source: CEIC

Inflation outlook

Compared to the US, EU, and UK, it is more obvious that Korea's inflation is heading towards the central bank's target range at a steady pace. It is true that core inflation is sticky at an elevated level, but it will come down to the 2% range in a couple of months. We do not expect additional utility fee hikes throughout the year as global commodity prices have stabilised while the decline in rent prices is expected to accelerate. Food inflation is also likely to ease due to recent declines in the prices of some staple manufactured foods.

Inflation is expected to stay in the 2% range



Source: CEIC, ING estimates

Bank of Korea watch

We forecast the Bank of Korea (BoK) will make its first move to cut its policy rate in the fourth quarter of this year before the easing cycle of other major central banks begins. Most importantly, we believe that inflation will hover in the 2% range by this point, so the BoK will be able to secure some room to adjust its policy direction.

Household consumption and business investment will likely be hampered quite considerably as the restrictive rate conditions last more than a year. We have already seen signs of credit distortion with rising delinquency rates and default rates, mostly in financially vulnerable groups.

As the global business cycle enters a downward phase, the BoK will gradually ease monetary conditions, supporting households and businesses to absorb the shock of the global slowdown. However, high levels of household debt and the widening gap between the US Federal Reserve will limit the pace of rate cuts in 2024.

Author

Min Joo Kang

Senior Economist, South Korea and Japan

min.joo.kang@asia.ing.com

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