Korea: Steady, but not exciting

Korea grew 2.7% in 2018, helped by a stronger-than-expected final quarter, which in turn was helped by some robust, but questionably sustainable growth in government spending. In 2019, the economy will struggle to grow faster than 2-2.5%

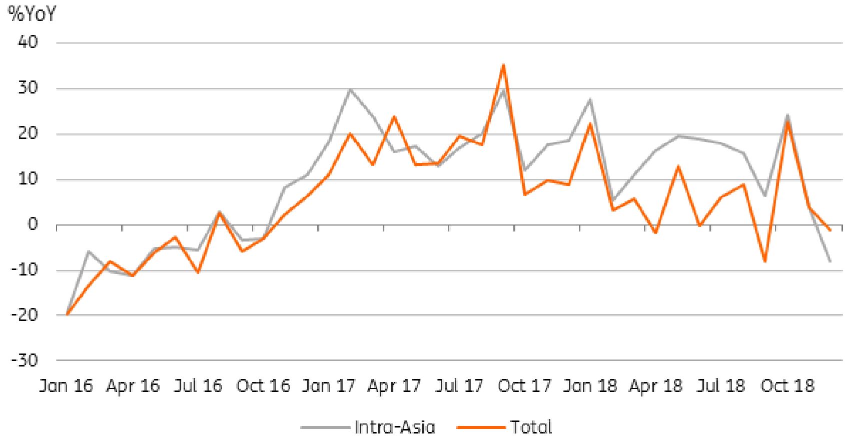
Source: Shutterstock

Economic activity – Growth under duress

Korea is a world class manufacturer of hi-tech and an exporting powerhouse. It is the fifth largest exporting nation on the planet, though ranks 11th in terms of GDP. In normal times, this enables the economy to punch well above its weight in terms of growth and corporate pricing power. These are not normal times.

The US-China trade war will claim many victims, but the closeness of supply chains in the Asia region means that important manufacturing players like Korea cannot hope to escape its effects. We can already see some signs of this in plunging export figures, but the damage runs deeper than just exports.

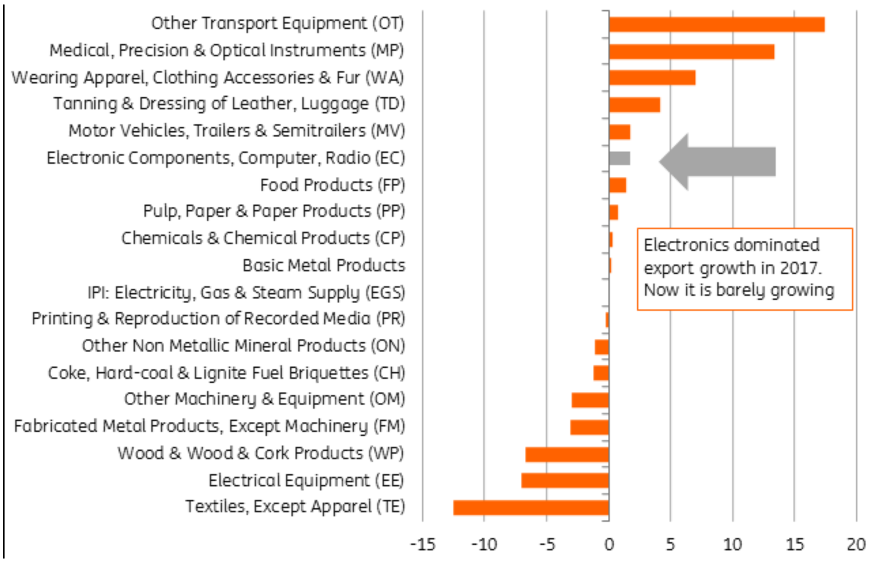
Export Growth - Intra Asia and total



Source: CEIC

In 2017, strong export growth was almost entirely driven by a resurgence in demand for electronics. Exports and output of other goods have barely improved since the financial crisis. Now the demand for these goods is softening. Overestimations of demand have led to overcapacity in many areas. Unit pricing is falling, and together with flat demand, this is squeezing profit margins.

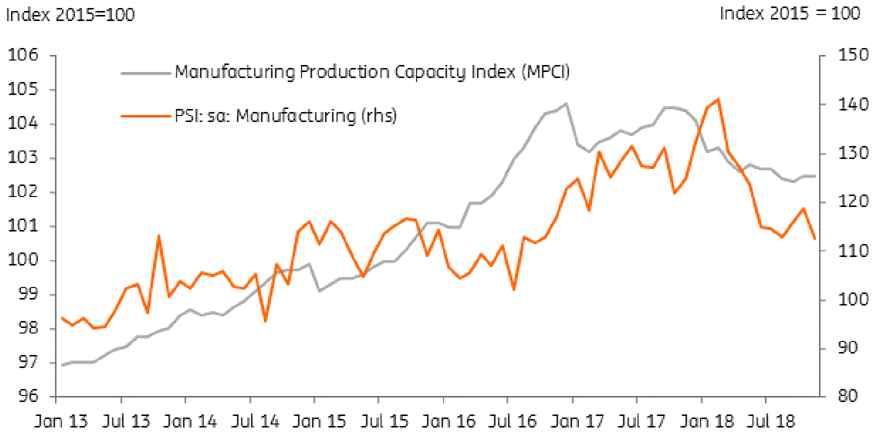
Export growth by type of product



Source: CEIC

The final flourish to 2018 GDP lifted our estimates for 2019 growth. Nevertheless, 2019 GDP will likely grow only in a 2-2.5% range (ING f 2.2%), rather than 2018's 2.5-3%. Korea is not alone. All of Asia is experiencing a growth slowdown. The US-China trade war is a significant part of the problem. Even a complete unwinding of all tariffs now would not lead to a return to prior growth rates. Some permanent damage has already been done. We don't expect such a reversal of the trade war anyway.

Production capacity index and output



Source: CEIC

With domestic demand likely to be weak and external demand not much better in 2019, we don't anticipate much change in Korea's trade or current account balances, with the forecast for 2019 of a 4.8% current account surplus close to the likely 2018 outcome.

Although the outlook for 2019 is heavily challenged, we see this as a temporary setback. Few doubt that the future of global prosperity lies in harnessing technological advancements, and that Korea is one of the best-placed economies globally to take advantage of that. It's just that at the moment, the distribution of much of that technology (5G) has not yet caught up with the hardware. That will change, if not in 2020, then surely by 2021. So this should just be a temporary, if rather lengthy, soft spot in an otherwise structurally sound and well-placed economy.

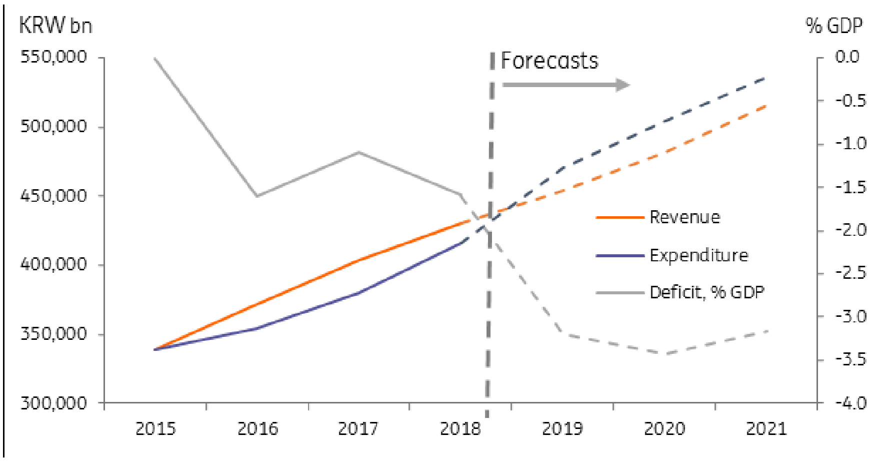
Likewise, the capacity excesses that are weighing on prices right now are in some ways not the worst sort of problem to have. This is an old-fashioned inventory excess and delivering an old fashioned growth slowdown. It also means that old-fashioned policy responses, accommodative monetary policy and easy fiscal policy, should provide some helpful offset until the excesses clear when private demand eventually returns.

Fiscal policy – deficit widening, intentionally and unintentionally

The Ministry of Finance and Economy's published budget for 2019 shows a sizeable expansion (+9.7%) in government spending in 2019 aimed at job creation, R&D, social security, welfare spending, wellbeing and national defence.

The net impact on the economy will be less than this, with government revenues also being increased 7.6% from 2018 (an 11.6% increase in tax revenues). Officially, this should lead to a rise in the deficit of only 0.2% GDP. We suspect the deficit will rise rather more than this (ING f deficit forecast is -2.6% of GDP on a consolidated basis ex social security), as revenue assumptions from corporate earnings are likely to be overestimated, along with nominal GDP estimates. The net fiscal stimulus will probably be about 0.2% of GDP, but the additional difference between the 2018 and 2019 deficits is cyclical and doesn't count towards economic stimulus.

Fiscal deficit (consolidated ex social security)



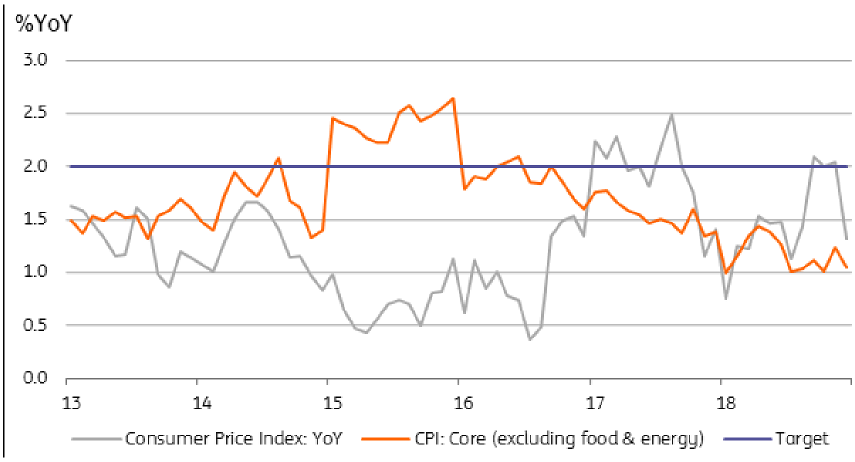
Source: ING, Ministry of Finance and Economy

Inflation – low, likely staying low

With a headline rate of inflation of 1.3%, and the same rate for core inflation, it really does not look like there is any notable price pressure in the economy, though saying that, as recently as a month ago, inflation had been trending at 2.0% or slightly above.

Some rewinding of earlier, higher food prices seems to have accounted for most of the headline decline, and such pipeline effects were fairly obvious before they happened. We can't forecast future weather-affected food prices, but absent any near-term shocks, inflation looks set to run well below the BoK's 2.0% target for the foreseeable future. Wages growth, meanwhile, is running at a fairly decent rate in excess of 2017 rates, though minimum wage increases will be underpinning some of this increase, and this should begin to drop out of wage figures in 2019 resulting in a slower pace of growth.

Korean inflation and BoK target



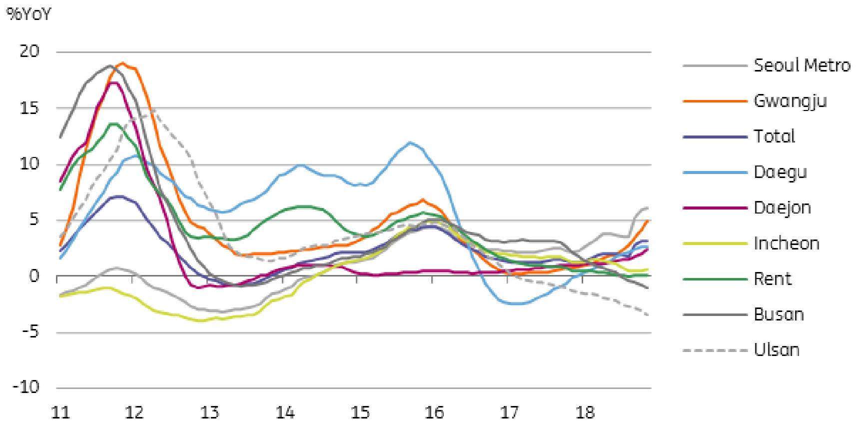
Source: CEIC

In fact, short of natural disasters or currency collapse, neither of which we are predicting, the outlook for Korean inflation remains extremely benign.

Monetary policy – nothing for ages, and then perhaps cuts not hikes

In an ideal world, the BoK's November rate hike of 25 basis points to 1.75% would be reversed this year. And sooner rather than later. We don't see this happening. The argument for the increase was not a strong one, resting on high ratios of household debt to disposable incomes, and a somewhat (but not very) elevated rate of house price growth and falling housing affordability in the Seoul metropolitan area.

Korean residential real estate prices %YoY



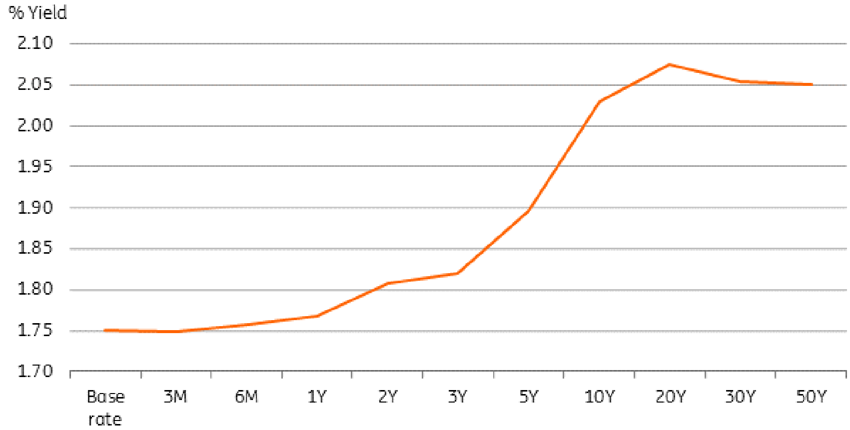
Source: CEIC

Responding to a perceived regional sectoral issue with a national policy response is always in danger of overkill, and on this occasion the timing seems to have been particularly unfortunate, coinciding almost to the day with a decline in national inflation.

We don't think 2018's hike will be reversed in 2019. Central Banks are as human as anyone else, and things would have to look spectacularly weak for them to affirm recent criticism of their hike by reversing it this year. Moreover, while we don't find the household debt argument for the hike a compelling one, household debt in Korea is high, and to that extent, now that rates have risen, we wouldn't encourage debt accumulation to go higher by cutting rates back again.

Moreover, saying that rates probably did not need to have been raised in 2018 is a different proposition to saying that they are too high now. Real rates are only slightly positive by about 40-45 basis points. That seems reasonable, though, one could make an argument for them being closer to zero as they are in many other Asian economies.

Korean sovereign bond yield curve slope



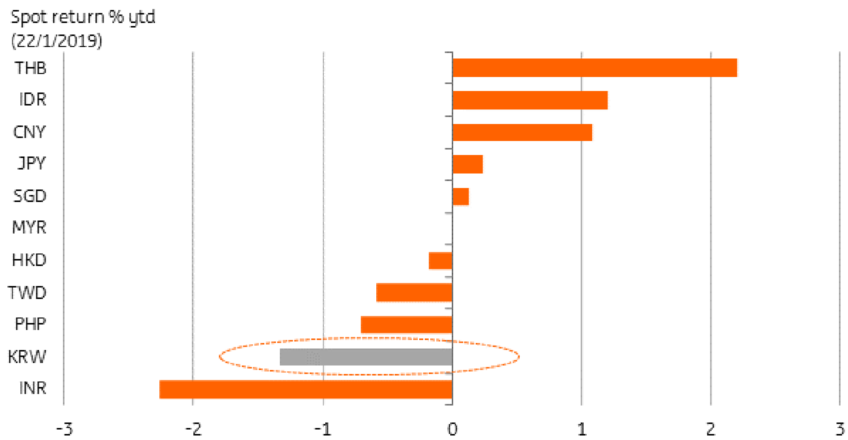
Source: Bloomberg

10Y KTBs are yielding only slightly more than 2.0% and the yield curve is exceptionally flat. Consensus forecasts for BoK base rates are also very flat, though there is a clear bias of forecasters towards tightening, recommencing next year. We are not sure that this is right. While that is probably the direction of travel, we can also see a case for rates to go down first, and the balance is probably only slightly tipped in the direction of hikes. That could change substantially.

Currency outlook – weaker first, then stronger

We can get some hint of the outlook for the Korean won from just looking at the first 22 days of the year so far, which shows the currency to have been the second weakest in Asia year-to-date, and second only to the Indian rupee. That is not a great place to be, though the outlook is not all bad.

Year to date Asian currency ranking



Source: Bloomberg

A lightening of the US-China trade war could play to renewed KRW strength. Though that remains a contentious call in our opinion - even despite recent optimistic noises from the US negotiating side.

More likely, the KRW will simply passively benefit from USD weakness later in the year, as opinions about the resilience of the US economy and Fed tightening expectations are reassessed.

We still think there is some chance of a final bout of US dollar strength this quarter that could see Asian FX and the KRW, in particular, under weakening pressure before a later recovery. This would be based on markets reassessing the positive frame of mind in which they started the year. Though given recent hints from both the Fed and US government, we may have to revise this starting assumption, which would likely result in some downward revision to the USD/KRW 1130 forecasts in 2H19 - essentially the same as today's rate. We are biding our time making this decision, and recent China growth disappointments mean that our current FX call has still not passed its sell-by date.

Forecast summary

	1Q19	2Q19	3Q19	4Q19	2019	2020	2021
GDP (%YoY)	2.1	1.7	1.9	2	1.9	2.8	2.4
CPI (%YoY)	1.7	1.7	1.4	1.8	1.7	1.6	2
Unemployment rate (eop)	4	4.1	4.2	4.1	4.1	4	3.8
Residential real estate (%YoY)	3.1	3.1	2.8	1.8	2.7	1.8	3.4
Fiscal Balance (consolidated ex soc sec)					-3.6	-4	-4
Debt/GDP (%)					41.3	43.1	45
Current a/c balance (US$bn and % GDP)	11.6	17.5	27.5	26.5	4.8	4.6	4.6
7-day repo rate (eop)	1.75	1.75	1.75	1.75	1.75	2	2.5
10Y yields (eop)	1.9	1.8	1.7	1.7	1.7	2.3	2.7
USD/KRW (eop)	1,150	1,140	1,130	1,130	1,130	1,100	1,080

Source: ING, Bloomberg, CEIC

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