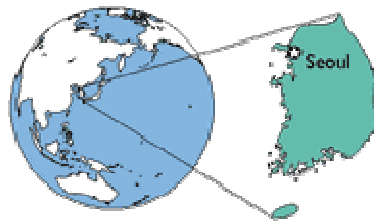


# COUNTRY REVIEW

## South Korea



1 April 2010

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**EULER HERMES COUNTRY RISK GRADE: BB**

Country Risk Grades are on a scale of AA, A, BB, B, C, D  
where AA is the lowest and D the highest risk.

## Strengths

- Firmly-established democracy.
- Fairly good international relations (though some regional tensions).
- So-called Newly Industrialised Economy with high per capita income.
- Reasonable economic policy track over the past years.
- Ample foreign exchange reserves.
- Manageable total external debt position.
- Well-established legal system and a reasonable level of bureaucracy support businesses.

## Weaknesses

- Geopolitical risk stemming from North Korea.
- Incomplete economic restructuring.
- Economic vulnerabilities (exchange rate, banking sector) to domestic and external shocks.
- High level of roll over debt obligations in the corporate sector.
- Weak corporate governance.

## KEY RISKS

- **Exchange rate volatility.**
- **Corporate refinancing risk (in particular SMEs and certain sectors).**
- **Banking sector weaknesses.**
- **Possibility of regime collapse in North Korea that could prove costly for the South.**

## Country Risk Assessment

Ratings	South Korea		Median	Brunei	Peers	Czech Rep.
	Latest	Previous	Grade BB		Mexico	
<b>Systemic Political Risk:</b>	<b>P2+</b>	<b>P2+</b>	<b>P2+</b>	<b>P2+</b>	<b>P2+</b>	<b>P2+</b>
<b>Systemic Economic Risk:</b>	<b>E3</b>	<b>E3</b>	<b>E3</b>	<b>E3</b>	<b>E3</b>	<b>E3</b>
ME rating:	ME3	ME3	ME3	ME3	ME3	ME3
<i>Structure</i>	3.3	2.6	3.3	5.0	2.3	1.6
<i>Policy</i>	4.2	4.3	4.2	4.6	4.0	4.3
<i>Solvency</i>	1.3	1.9	1.9	1.0	1.9	1.3
<i>External Liquidity</i>	2.2	5.2	3.3	2.8	3.6	5.2
SBE rating:	SBE2	SBE2	SBE2	SBE3	SBE3	SBE2
<b>COUNTRY GRADE:</b>	<b>BB</b>	<b>BB</b>		<b>BB</b>	<b>BB</b>	<b>BB</b>

**Nomenclature:**

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Economic Studies

## ECONOMIC STRUCTURE

<b>Country Profile</b>	
Capital city:	Seoul
Population:	48.152 mn (2008)
GDP:	USD 929122 mn (2008)
Currency:	South Korean won (KRW)
Form of state:	Presidential republic
Head of government:	President LEE Myung-bak (since 25 February 2008)
Next elections:	President: December 2012 / Legislative: April 2012

<b>Major Industries (% of GDP at market prices, 2008)</b>		<b>Global Assumptions</b>		2009	2010
Services	60.3%	Real GDP grth (% yr/yr) *		-3.9	0.9
Trade	11.0%	Inflation (% av) *		-0.1	1.3
Industry	37.1%	Dated Brent (USD/b)		61	72
Manufacturing	28.1%	* Major economies			
Agriculture	2.5%				

<b>Main Exports (% of total, 2007)</b>		<b>Main Imports (% of total, 2007)</b>	
Electronic products	13.6%	Machines, transport equipment	30.1%
Chemicals	9.9%	Mineral fuels, etc.	27.0%
Machinery and precision equipment	9.7%	Basic manufactures	14.6%
Iron and steel products	8.5%	Chemicals	9.1%
Ships and boats other than warships	7.2%	Crude materials excluding fuels	6.7%
<b>Lead Export Markets (% of total exports, 2008)</b>		<b>Lead Import Markets (% of total imports, 2008)</b>	
China, PR	23.9%	Middle East	19.1%
South East Asia	19.3%	China, PR	16.8%
EU	12.8%	Japan	15.3%
USA	10.4%	South East Asia	14.0%
Japan	6.0%	EU	10.0%

## Basic indicators

<b>Selected economic indicators</b>	2006	2007	2008	2009	2010f
Nominal GDP (USD mn)	951,774	1,049,236	929,123	825,731	1,012,978
Population (mn)	47.77	47.96	48.15	48.34	48.52
GDP per capita (USD)	19,926	21,876	19,296	17,082	20,876
Real GDP growth (% yr/yr)	5.2	5.1	2.3	0.2	4.5
Inflation (% eop)	2.1	3.6	4.1	2.8	3.5
Fiscal balance (% of GDP)	-1.2	0.4	-1.6	-5.3	-6.3
Current account balance (% of GDP)	0.6	0.6	-0.6	5.2	3.0
External debt/GDP (%)	27.3	36.5	40.7	48.7	39.4
External debt/Exports of goods & services (%)	68.1	86.6	74.1	93.0	80.5
Debt-service ratio (%)	6.1	6.9	6.5	8.9	7.4
Foreign exchange reserves (USD mn)	238,388	261,771	200,479	265,202	280,000
Import cover (months)	7.7	7.2	4.6	8.1	7.1
Exchange rate assumption, KRW:USD (av)	955	929	1,102	1,277	1,120
Exchange rate assumption, KRW:EUR (av)	1,199	1,273	1,606	1,773	1,568
f: CRU central forecast					

Sources: Bank of Korea, National Statistical Office, IMF, ADB, ECB, Euler Hermes Economic Studies

## Political Stability

South Korea has a firmly established and durable democratic framework. The military is no longer a political force. The president is the head of state, the chief executive of the government and commander-in-chief of the armed forces, serving a single five-year term by direct election. The unicameral National Assembly is elected once every four years. Power is relatively highly concentrated among the elite, however, and this has had negative implications on public confidence.

After a decade in opposition to centre-left governments, the conservative Grand National Party (GNP) regained full control of the political scene through winning the presidential election in December 2007 and the parliamentary election in April 2008. The GNP currently commands 169 out of 299 parliamentary seats, a sufficient majority for overall effective policymaking even though the party is fractious, party defections are quite common and initially strong public confidence in President Lee Myung-bak has weakened as his campaign pledge to a firm pro-growth platform has been disrupted by the impact of the global economic crisis.

Foreign policy will continue to be determined by geopolitical risk stemming from North Korea. Military conflict is unlikely, but the nuclear issue remains a threat. Six-nation talks (among the two Koreas, China, Japan, Russia and the US) on the North's nuclear disarmament have been on-again, off-again since 2003, frequently interrupted by North Korea violating earlier made agreements. The latest such incident was the North's second nuclear test in May 2009. Moreover, should the North Korean regime collapse eventually, possible reunification could prove economically costly for the South and lead to increased social and political instability. In the longer term, South Korea will continue to sit uneasily between the region's two main powers, Japan and China, relations with which have been tense at times.

## Economic Stability

The intensification of the global financial and economic crisis in September 2008 initially hit South Korea harder than most regional peers. Accelerating capital flight—as risk aversion to emerging economies grew sharply then—and concerns about a foreign exchange (FX) liquidity shortage in the Korean banking sector pushed the local currency, the won (KRW), to a decade record low against the USD in October 2008 and caused financial markets tumbling. In the months thereafter, the KRW remained highly volatile and fell to another decade record low in March 2009. Moreover, exports collapsed—suffering a record 35% yr/yr slump in January 2009—which spilled over to investment and private consumption because of the economy's openness to trade. Since Q2 2009, however, markets have rebounded substantially and the economy has recovered fairly quickly.

Robust real GDP growth averaged 4.7% in 2004-2007 and 4.4% in Q1-Q3 2008, mainly driven by domestic demand, in particular by sound private and government consumption. Then real GDP shifted sharply to yr/yr contraction of 3.3% in Q4 2008, 4.3% in Q1 and 2.2% in Q2 2009, before it rebounded to growth of 1% in Q3 and 6% in Q4 2009. The steady recovery in the course of 2009 was largely driven by strong government consumption and supported by a positive net contribution of external demand as exports shrank less sharply than imports. Private consumption and investment declined significantly in Q1-Q3 but returned to modest growth in Q4. Overall, real GDP grew 2.3% in 2008 and 0.2% in 2009. Owing to base effects, growth is forecast to be strong in H1 2010 and to moderate gradually thereafter, resulting in 4.5% or so for the calendar year.

Thanks to reasonably prudent fiscal policy, the central government has recorded small fiscal deficits or surpluses in 2000-2008. Substantial fiscal stimulus in order to mitigate the economic downturn and lower fiscal revenues due to lower GDP growth have resulted in a larger fiscal deficit of about 5.3% of GDP in 2009. A similar deficit is expected in 2010. As a consequence, public debt has increased from 32% of GDP in 2008 to about 40% in 2009 and is forecast at 47% in 2010. However, these figures are not yet a cause of serious concern. Like other countries in the region, South Korea had a relatively strong macroeconomic position going into the global crisis, allowing sufficient fiscal expansion and also monetary policy relaxation to support the economy. Moreover, public debt is almost entirely domestic debt. Once the economy has stabilised on a sustainable basis, the government should be able to return to fiscal prudence.

Inflation has been under control for many years. It peaked at 5.9% yr/yr in July 2008 owing to then record high world oil prices, but this was still relatively low as compared to peers in Asia and elsewhere. Inflation has since moderated to an average 2.8% in 2009 and stood at 2.7% yr/yr in February 2010. The Bank of Korea (BOK, the central bank) has set an inflation target of 2-4% for 2010-2012 which we expect to be achieved at least this year.

The exchange rate of the freely floating KRW became highly volatile in the wake of the intensifying global financial crisis in H2 2008 and the currency lost more than 50% against the USD from mid-2008 to early March 2009. However, a total meltdown was avoided thanks to occasional but decisive intervention by the BOK, the securing of swap lines from other central banks totalling USD90bn and a USD130bn government financial stabilisation package. Since Q2 2009, the KRW has stabilised and regained much of the earlier losses against the USD.

Following 10 years of surpluses, the current account shifted into a small deficit of 0.6% of GDP in 2008, as record high oil prices pushed up imports in H1 and, in H2, exports initially suffered more than imports from the impact of the global economic slump. This picture changed in the course of 2009 when exports recovered earlier than imports, contributing to an estimated current account surplus of 5.2% of GDP. We expect a still solid 3% surplus in 2010.

FX reserves had fallen from a peak of USD264bn in March 2008 to temporary low of USD200bn in November 2008, mainly owing to capital flight and foreign exchange selling by the central bank in order to defend the exchange rate at that time. Markets turned nervous because of the rapid fall even though the absolute level was still large. However, the decisive economic policy response and the following economic recovery ended the downtrend in FX reserves which have since rebounded to around USD270bn in early 2010. This is sufficient to cover over seven months of expected imports and more than all short-term debt and principal repayments due in 2010.

The external debt-to-GDP ratio has risen from 37% in 2007 to a less comfortable 49% in 2009, largely owing to the KRW depreciation and the accompanying fall of GDP in USD terms. But we expect the ratio to improve again to about 40% in 2010. Moreover, external debt in relation to export earnings is still adequate at below 100% and the debt-service ratio will remain comfortably below 10% in 2010.

### Structural Business Environment

The Structural Business Environment is fairly strong, though just short of our highest category. Positive features include relatively low barriers to capital flows and foreign investment, a well-established legal system that protects property rights and a moderate level of regulation where bureaucracy does not materially impede the day-to-day business operations. Transparency International's *Corruption Perception Index 2009* puts South Korea at rank 39= out of 180 countries, slightly behind Portugal (35=) but better than Malta (45) and Hungary (46=), for example. Weaknesses relate to incomplete economic restructuring in some areas. Business concentration in the economy remains high and the chaebol (large business conglomerates) still dominate the corporate landscape. Several scandals in recent years have underscored the weak corporate governance environment.

Following the 1997-98 Asian financial crisis, the banking sector has been restructured, liberalised and recapitalised in order to become more competitive, transparent and efficient and to end state-directed lending. Nonetheless, the sector has since faced serious problems such as the consumer credit and credit card crisis in 2002-04, continued financial difficulties of small- and medium-sized enterprises (SMEs) and a threatening housing bubble. Moreover, the ongoing global financial crisis caused substantial strain on the banking sector in the immediate aftermath of the Lehmann Brothers bankruptcy when the dependence of many banks on offshore funding resulted in a severe FX liquidity shortage within the sector due to the suddenly intensified global credit crunch as well as accelerating capital flight. Thanks to quick and decisive central bank and government action, a banking crisis was avoided and, all in all, the sector has weathered the financial turmoil relatively well. But the aforementioned problems highlight that the banking sector is still vulnerable to domestic and external shocks and the IMF has recommended improved bank supervision and regulation.

In the near term, weaknesses in the household and corporate sectors are likely to affect banks' relatively strong capital positions as the number of insolvencies and the share of non-performing loans in total loans will stay above 2007 levels though they will remain below the averages of the past decade. In an August 2009 report the IMF concluded that aggregate corporate health was strong before the global crisis and still solid in mid-2009 when domestic and external financing conditions were already easing. However, the report suggested that within the corporate sector SMEs as well as companies in the construction, real estate, shipping, IT hardware, consumer durables and automotives sectors were particular vulnerable to the impact of the global crisis. The report further concluded that creditor losses from corporate insolvencies could reach 4-6% of GDP, though this was assumed to be manageable for the banking system.

**Charts**

