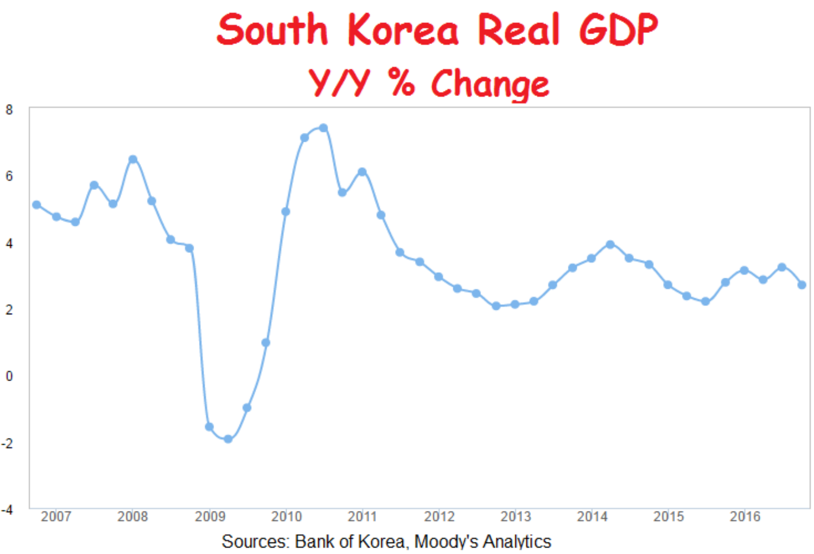
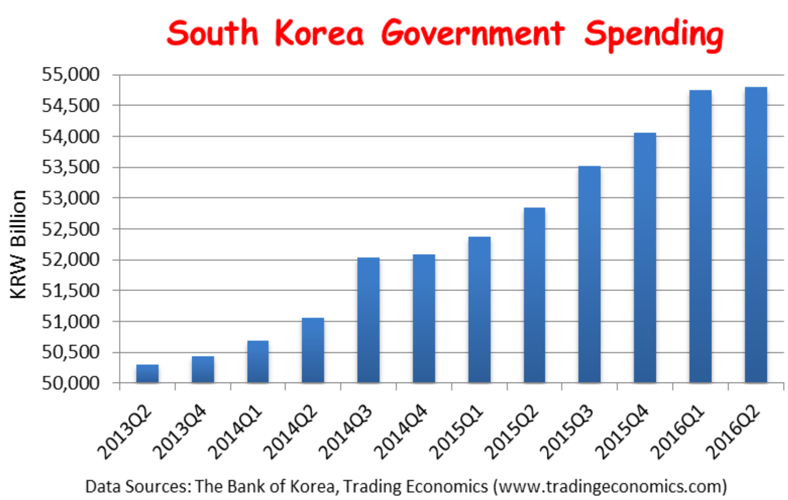
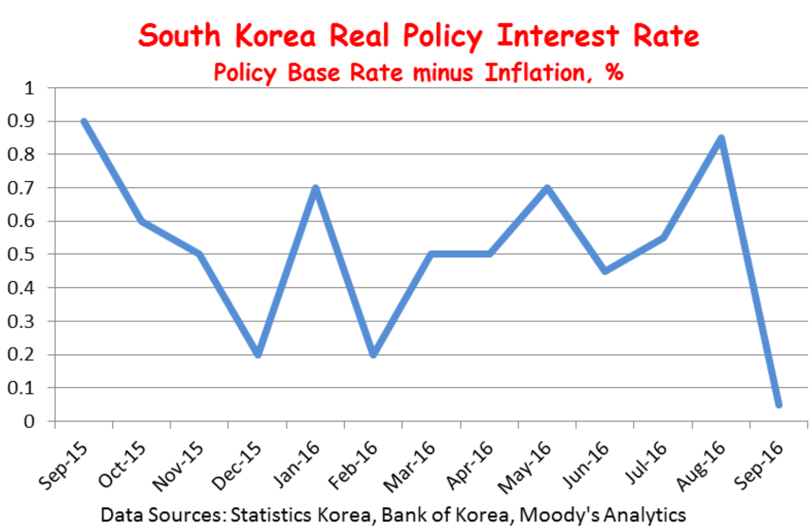
South Korea's Economic Outlook



The Korean economy has been struggling to gain steam. Growth took a dip in 2014 after a ferry disaster, when private spending declined. Although the economy has recovered slightly, economic growth has been restricted by reduced global demand and increasing household debt. As a result, real GDP grew by 3% in 2015, close to Korea's potential growth rate. This year's performance has also been discouraging with year-over-year growth during the first three quarters averaging 2.9%.

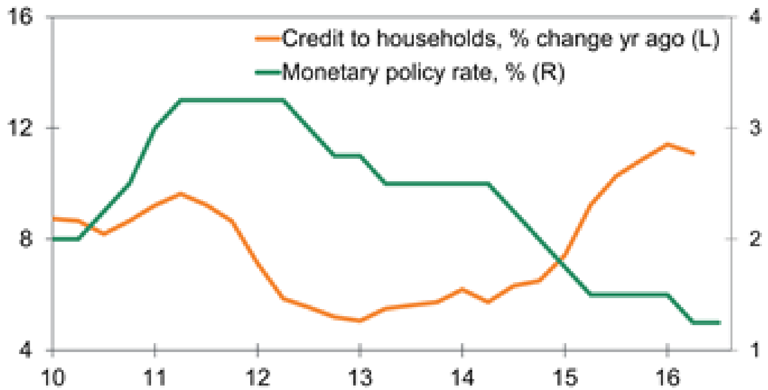


The sluggish domestic economy has prompted more aggressive expansionary fiscal and monetary policy. In June, the government announced a $17 billion stimulus package in hopes to jumpstart the economy. The stimulus program includes a special focus on financing the restructuring of many export-oriented businesses, particularly the debt-laden shipbuilding and shipping businesses, and creating jobs for laid-off workers in those industries. Meanwhile, the Bank of Korea is continuing its fifth year of monetary easing, with the policy interest rate being reduced to a record low of 1.25% in June.



Thankfully, the government's stimulus efforts are beginning to have a positive impact. In September, Korea's inflation rate reached a 7-month high of 1.2%. Korea has been struggling with low inflation for a while due to weak domestic demand and lower oil prices; however, rising retail sales and improved sentiment have recently helped raise consumer prices. While this is good news, Korea's inflation rate is still well below the Bank of Korea's 2% target. Nevertheless, the combination of the uptick in inflation and the government's rate cuts has allowed the real borrowing rate to drop to close to 0%.

South Korea Household Credit vs Policy Rate

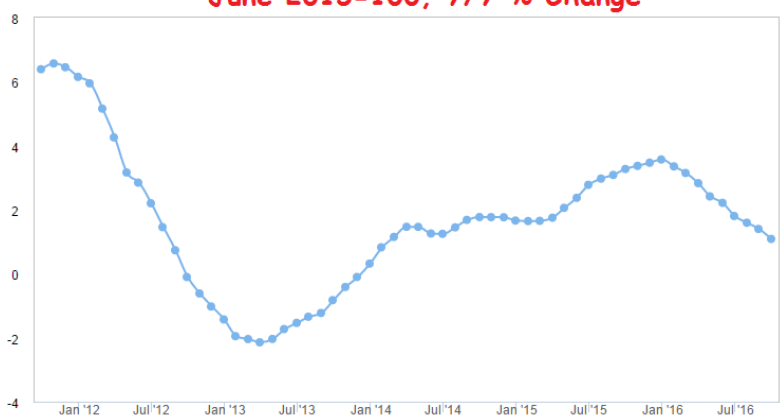


Sources: The Bank of Korea, Moody's Analytics

While domestic demand could improve in the coming months, private spending will continue to be weighed down by the nation's high level of household debt. Korea has been struggling with an increase in household debt for a long time and, unfortunately, the situation is getting worse. Growth of household debt has accelerated over the past few years, with debt levels reaching almost 90% of Korea's GDP; this is a major risk to the Korean economy. Although the government's stimulus efforts are helping to boost spending, they are also fueling demand for credit, which is exasperating the household debt issue.

South Korea Home Prices

June 2015=100, Y/Y % Change

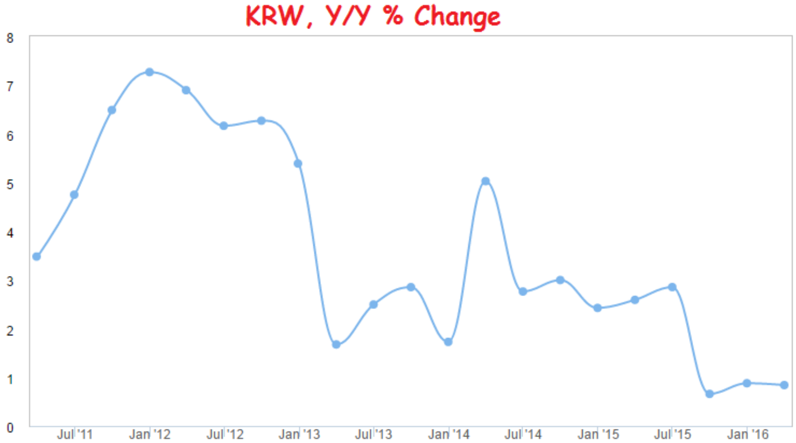


Sources: Statistics Korea, Moody's Analytics

Korea's high household debt issue is mostly due to the widespread homeownership in the country, as well as the borrowing of money to finance expenses such as education. As such, the biggest risk to Korea's household debt problem is a sharp decline in home prices. Thankfully, after a long period of declining home prices, we are seeing gains; record-low interest rates have helped to boost activity in the housing market. While this is good news, it is also worsening the nation's debt problem and has prompted the government to encourage banks to implement a stricter screening process for home loans.

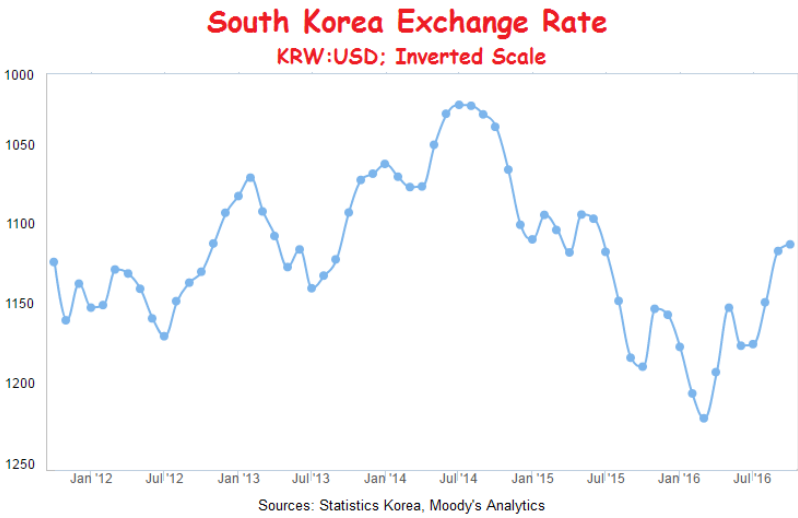
South Korea Household Income

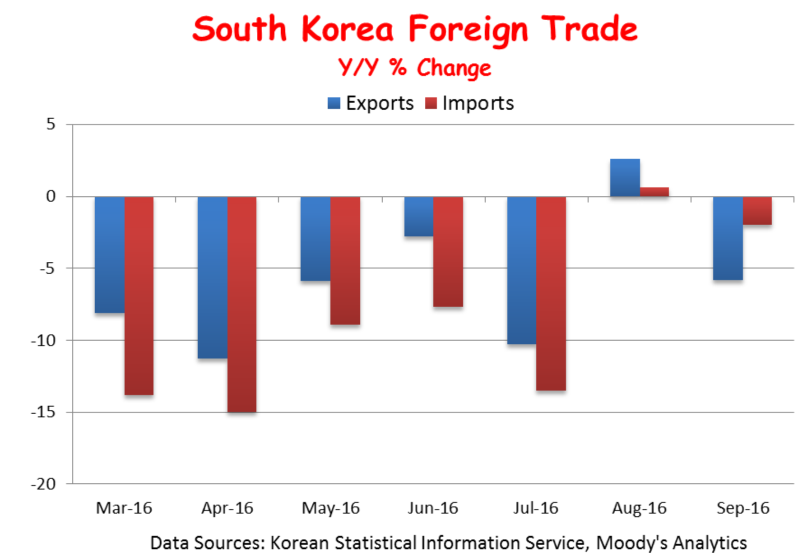
KRW, Y/Y % Change

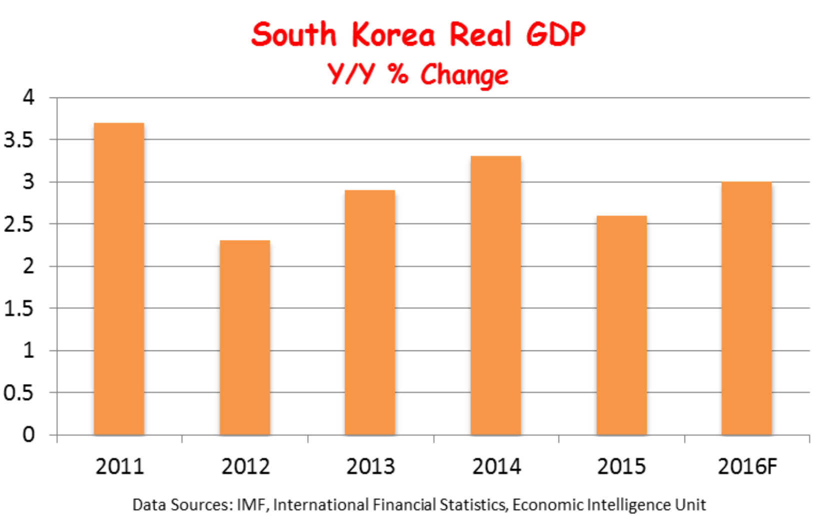


Sources: Statistics Korea, Moody's Analytics

Further, although Korea's home prices are rising, they remain weak. The lackluster recovery of home prices is mainly the result of slowing income growth. Weak domestic demand is weighing on production and, consequently, labor demand. As a result, year-over-year income growth has slowed to less than 1%. In order for home prices to grow at a faster rate, income growth needs to pick up. This will only occur when household spending rises and firms are confident enough to increase their demand for labor. While the government's stimulus efforts should provide some relief in the near term, it will likely take a few years until we see significant improvement.







In addition to weak domestic demand, Korea is also struggling with reduced external demand. This is concerning since Korea is very dependent on external demand for growth; exports alone account for over half of the country's GDP. Although the central bank's recent rate cuts have helped weaken the won compared to a couple of years ago, the currency remains elevated. The strong currency reduces the price competiveness of Korean exports and therefore hurts export-oriented firms.

In addition to the strong won, slowing economic conditions in China, Korea's leading export market, have also caused Korea's exports growth to suffer; exports to China account for over a quarter of the Korea's total exports. Meanwhile, cooling conditions in the U.S. and uncertain conditions in the Eurozone are also taking a toll. As a result, export growth has remained in negative territory in all but one of the last 20 months and will likely remain weak in the near term given the elevated won, tepid global demand and slowing Chinese economy.

Unfortunately, Korea's imports growth has also been discouraging. Weak domestic demand and lower oil prices have caused import receipts to decline for most of the last two years. While conditions may improve slightly over the next few months due to the anticipated boost in private spending, import demand will remain weak until domestic demand demonstrates a substantial recovery.

Overall, Korea's economy is struggling. Domestic demand could pick up slightly over the next few months as a result of the government's stimulus efforts, although it will continue to be weighed down by the high level of household debt. Meanwhile, the elevated won and China's economic slowdown will continue to reduce exports. The economy is expected to continue its snail-pace recovery and grow less than 3% this year, close to the 2.6% in 2015.