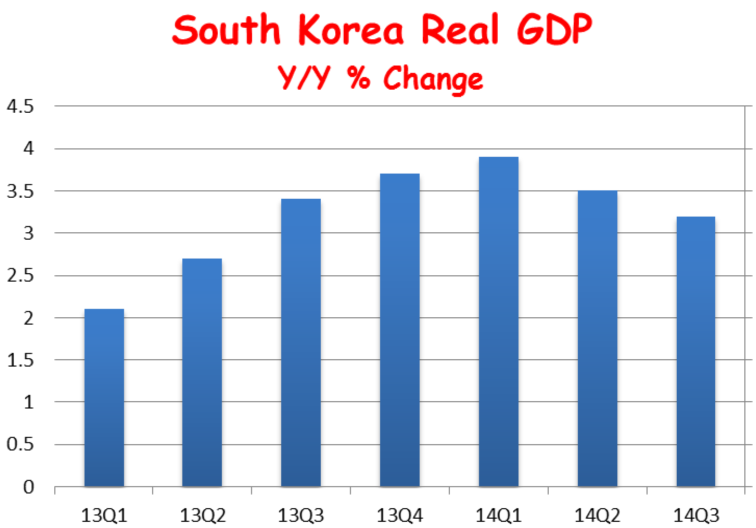
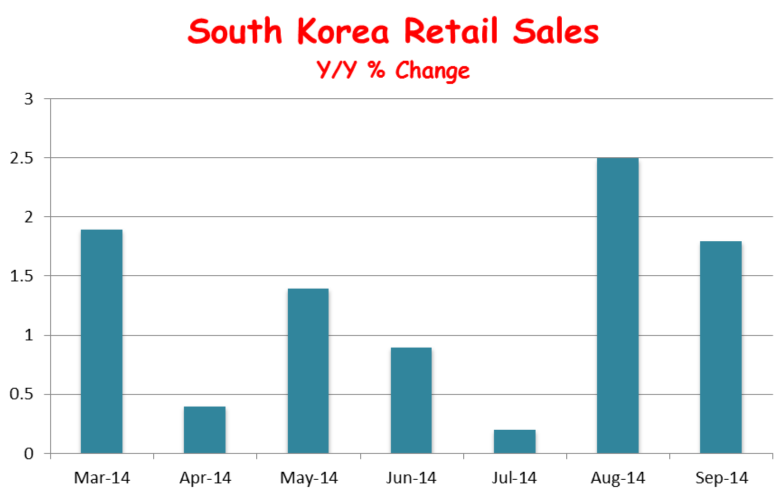
Korea's Economic Outlook



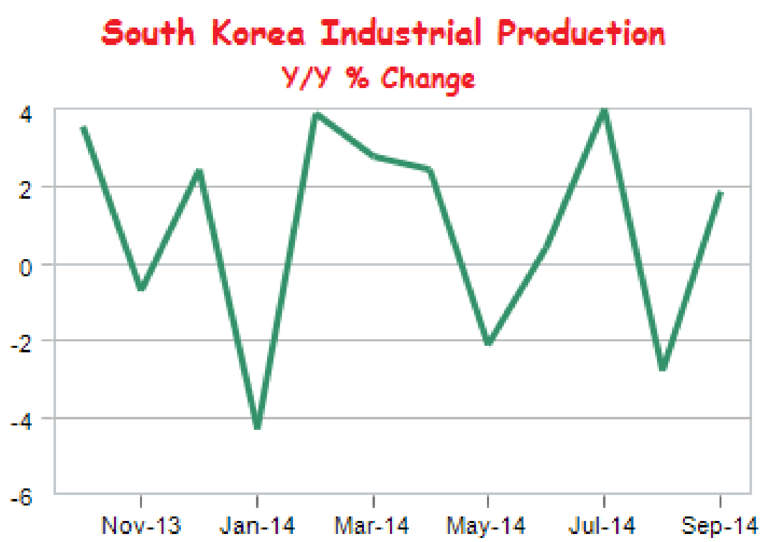
Data Sources: Korean Statistical Information Service, Moody's Analytics

The Korean economy is struggling to regain its momentum in its recovery from a three-year soft patch. Growth took a dip after April's ferry disaster, which led to the death of almost 300 passengers and caused a drop in private spending by households and businesses. The sluggish domestic economy has prompted more aggressive expansionary fiscal and monetary policy. The government has announced plans to increase spending by 5.7% in 2015, the biggest increase in 5 years. Meanwhile, the Bank of Korea cut the policy interest rate in October for the second time in three months to 2%.



Data Sources: Korean Statistical Information Service, Moody's Analytics

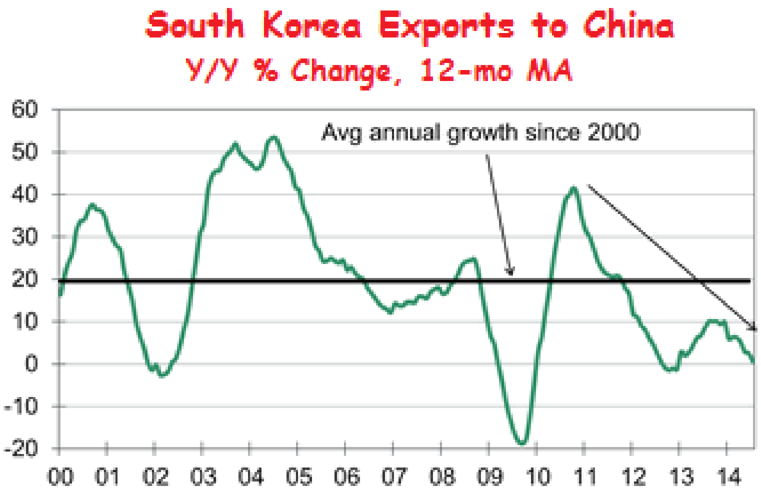
Thankfully, domestic demand is showing signs of a rebound through an increase in household spending. Korea's retail sales are rising, driven by improvements in the labor market and government stimulus efforts. Employment has increased in almost every industry in Korea this year. Higher incomes and lower interest rates have helped boost consumer confidence and consumption. Spending is expected to stay strong in the coming months given the strong labor market conditions.



Sources: Korean Statistical Information Service, Moody's Analytics

Despite Korea's domestic demand picking up, industrial production has been disappointing, primarily due to a decline in motor vehicle output as a result of strikes in the auto industry. Recent wage deals should help boost production levels in the near term.

Industrial production has also been hit due to a drop in export demand from China. The Chinese government has taken steps to reduce the country's reliance on exports, which is hurting Korean manufacturers. In particular, Korea's electronics and petrochemical makers are struggling as a result of China's increased energy self-sufficiency and production of smartphones.



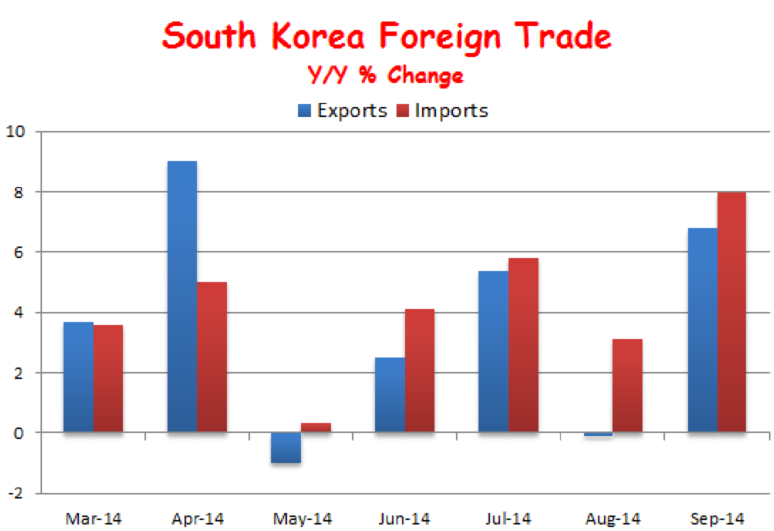
Sources: Ministry of Trade, Industry and Energy, Bloomberg, Moody's Analytics

Reduced demand from China is concerning because China currently makes up about a quarter of Korea's export market. Adding to the problem is the continual strengthening of the Korean won, with the won reaching nearly a six-year high against the Chinese yuan. The appreciation of the won has been primarily due to an increase in investment by foreign investors as a result of improved economic conditions in Korea. The strong currency reduces the price competiveness of Korean exports and therefore hurts export-oriented firms.

The recent rate cuts by the central bank are expected to reduce foreign and domestic investment in Korean assets. This will reduce the demand for won to purchase Korean assets. As a result, it is expected that the won will weaken in the near term, which should provide some relief in the coming months.

Sources: Bank of Korea, Federal Reserve, Moody's Analytics

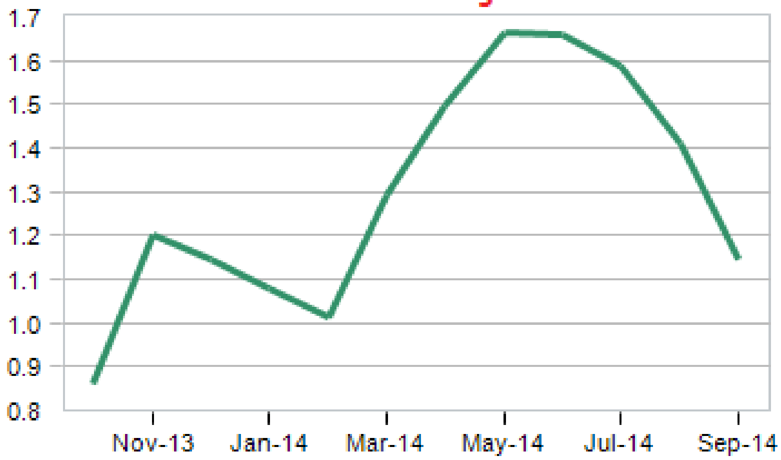
Thankfully, stronger global demand for Korea's consumer electronics products, including smartphones and notebooks, has kept Korea's overall exports growing at a healthy rate. The release of new consumer electronics, such as the iPhone 6, has strengthened these gains since Korea is a large supplier of its components. Export growth is expected to remain strong as global demand gains momentum, although the elevated won has potential to curb these gains.



Data Sources: Korean Statistical Information Service, Moody's Analytics

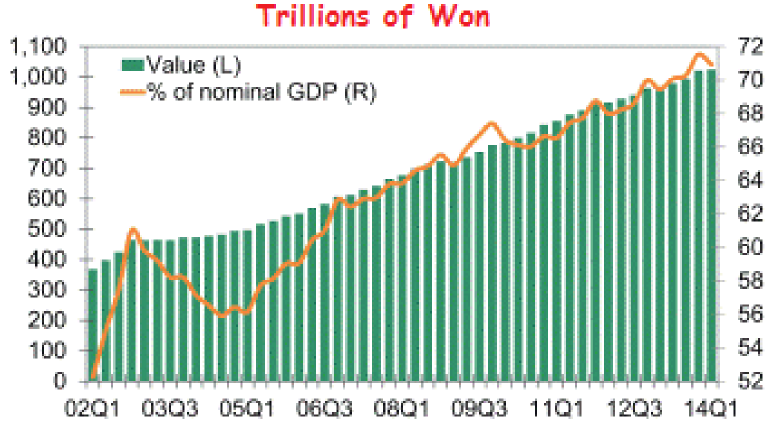
As a result of Korea's stronger domestic demand, imports have increased. Import demand has also been lifted by the appreciation of the won, which has reduced the relative price of imports. Import growth is expected to remain strong in the near term as the domestic economy rebounds from its current soft patch. Imports will also continue to be supported by the strong currency.

South Korea Consumer Price Index
Y/Y % Change



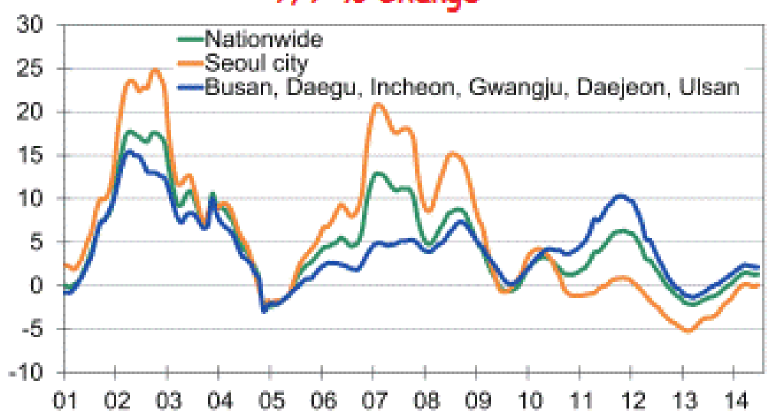
Sources: Korean Statistical Information Service, Moody's Analytics

South Korea Household Credit
Trillions of Won



Sources: Bank of Korea, Moody's Analytics

South Korea House Prices
Y/Y % Change



Sources: Statistics Korea, Moody's Analytics

Korea's inflation rate has dropped over the last few months to nearly a one-year low due to the current slowdown and elevated won. Falling prices have raised concerns of deflation, leading the central bank to cut the policy rate in an effort to boost prices. Price pressures will likely increase over the near term as Korea's domestic demand strengthens. As the rate cuts cause the won to weaken, prices will also be boosted by higher imported inflation.

While consumer spending has been a key engine of Korea's economic growth, it has also increased household debt. Korea has been struggling with an increase in household debt for a long time. The prolonged upward trend in debt levels has raised concerns of a financial crisis, which is why this issue is a major concern for Korea's economy.

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, higher incomes and lower interest rates are having a positive effect on Korea's housing market. After a long period of declining home prices, we are seeing gains.

Nevertheless, home prices remain weak. The government has announced plans to reduce housing restrictions by increasing the debt-to-income and loan-to-valuation ratios by 10%. Younger individuals will also be allowed to borrow more money against future incomes. These plans are expected to boost housing demand and prices in the coming months; however, they will also worsen the nation's household debt issue.

Overall, while Korea's economy is recovering, it has experienced a slowdown. Economic growth is expected to rebound in the coming months as the domestic economy recovers and global demand strengthens. The biggest macroeconomic risk for Korea is the rising household debt levels. The elevated won also has potential to curb exports, which could hurt growth. A continued slowdown in exports to China is also a threat to Korea's economy. The economy is expected to grow by around 3.5% this year, up from 3% in 2013.