

Summary

The death of North Korea's dear leader, Kim Jong-il, has increased political uncertainty within North Korea, as his successor, Kim Jong-un, is young and inexperienced. This also translates into increased uncertainty for South Korea. Regarding South Korea's economy, monetary tightening and lower external demand in the second half of last year have caused real GDP growth to undershoot earlier estimates slightly, growing by 3.3% last year. For 2012, a more or less similar growth rate is expected, although weakening global growth poses a downside risk. At 4% in 2011, inflation was at the upper band of the central bank's target range and monetary policies have therefore not (yet) been loosened, in spite of the worsened growth outlook. South Korea will hold parliamentary and presidential elections this year. The ruling GNP is set to lose its majority, as the party is internally divided, plagued by scandals and has failed to deliver on its promises.

Things to watch:

- Political developments in North Korea after the death of Kim Jong-il
- Declining demand for exports due to slowing global growth
- Parliamentary and presidential elections this year

Author:

Erwin Blaauw
Country Risk Research
Economic Research Department
Rabobank Nederland

Contact details:

P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21-62648
E.R.Blaauw@rn.rabobank.nl

South Korea			
National facts		Social and governance indicators	
Type of government	Republic	Human Development Index (rank)	15 / 187
Capital	Seoul	Ease of doing business (rank)	8 / 183
Surface area (thousand sq km)	100	Economic freedom index (rank)	35 / 179
Population (millions)	49.5	Corruption perceptions index (rank)	43 / 183
Main languages	Korean	Press freedom index (rank)	42 / 178
	English	Gini index (income distribution)	31.59
Main religions	Christian (26%)	Population below \$1.25 per day (PPP)	n.a.
	Buddhist (23%)		
	None (49%)		
Head of State (president)	Lee Myung-bak	Foreign trade	
Head of Government (prime-minister)	Kim Hwang-sik	2009	
Monetary unit	South Korean won (KRW)	Main export partners (%)	Main import partners (%)
		China	25
		US	11
		Japan	6
		Hong Kong	5
		China	17
		Japan	15
		US	10
		Germany	3
Economy		2011	
Economic size		<i>bn USD</i>	<i>% world total</i>
Nominal GDP	1099	1.59	
Nominal GDP at PPP	1485	1.88	
Export value of goods and services	652	2.98	
IMF quatum (in mln SDR)	2927	1.35	
Economic structure		2011	5-year av.
Real GDP growth	3.3	3.8	
Agriculture (% of GDP)	2	3	
Industry (% of GDP)	40	37	
Services (% of GDP)	47	49	
Standards of living		<i>USD</i>	<i>% world av.</i>
Nominal GDP per head	22139	205	
Nominal GDP per head at PPP	29915	243	
Real GDP per head	21185	261	
		Main export products (%)	
		Information & communication products	13
		Semiconductors	10
		Chemicals	10
		Machinery & equipment	9
		Main import products (%)	
		Crude petroleum	18
		Machinery & equipment	12
		Chemicals	9
		Semiconductors	8
		Openness of the economy	
		Export value of G&S (% of GDP)	59
		Import value of G&S (% of GDP)	57
		Inward FDI (% of GDP)	0.30

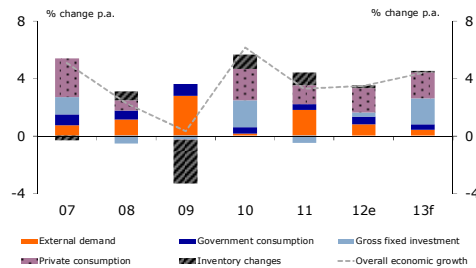
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Introduction

South Korea recovered rapidly from the global financial crisis, with growth accelerating to 6.2% in 2010 on the back of strong domestic and international demand. In 2011, real GDP growth slowed to 3.3%, while 4.2% was estimated earlier. Demand pressures and rising food and oil prices pushed inflation to 4% in 2011, which is at the upper band of the Bank of Korea's (BoK) target range. This prompted the BoK to tighten monetary policies at a faster pace, raising the base rate to 3.25% in 2011. Monetary tightening and weaker than expected export growth in the second half of the year were responsible for the worse than anticipated economic performance last year. The trade surplus also fell as a result and, as the global economy is expected to slow in 2012, demand for South Korea's exports will slow as well. This will lead to a further narrowing of the trade surplus in 2012 to 1.7% of GDP, from 3% last year. Inflation is currently expected to come in at a relatively low 2.5% in 2012, which, in combination with the recent weakening of growth might persuade the BoK to lower interest rates at some point this year. The government's budget returned to its usual surplus again in 2010, after one year of posting a deficit in 2009, and showed a surplus of 2.1% of GDP in 2011. As trade grew less rapidly than expected, short-term debt also did not increase as rapidly as expected. As a result, total foreign debt remained close to USD 400bn, or roughly 35% of GDP. The share of short-term debt in total foreign debt decreased slightly as a result, to around 39% in 2011. FX-reserves did increase as anticipated, to USD 320bn. This implies an import cover ratio of around 6 months. Real GDP growth is estimated to remain more or less steady at 3.5% in 2012, although a worse than anticipated slowdown of external

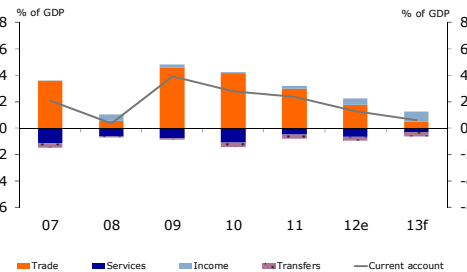
demand presents a significant downside risk. The economic performance of China, South Korea's main trade partner, will be important in this regard. The Chinese economy is expected to continue on its soft landing trajectory, with growth slowing to 8% in 2012, although significant downside risks to China's growth performance are present as well.

Figure 1: Growth performance



Source: EIU

Figure 2: Current account



Source: EIU

The death of Kim Jong-il

The death of North Korea's "Dear Leader" Kim Jong-il on December 17th 2011 has created further uncertainty for South Korea. His successor, his son Kim Jong-un, who has since become known as the "Great Successor", will take on all the top official positions in the coming year. The main related risks for South Korea are, firstly, that the new North Korean leader will feel it is necessary to give a show of aggression towards South Korea to improve his status domestically, especially within the military. Secondly, Kim Jong-un is young at 28 years old and inexperienced. This increases the risk that an internal leadership struggle will break out in North Korea. This could also translate into aggression towards South Korea and would lead to a costly inflow of North Korean refugees. Finally, Kim Jong-un may also speed up reforms, which could eventually also lead to an even more costly re-unification of the two countries, but this scenario is still far away. So far, Kim Jong-un seems to continue along the same policy lines as his father did. He has spoken out in support of North Korea's nuclear program and has not shown any increased signs of aggression towards South Korea. It also seems that his succession was well-planned after all. Those who surround him are in firm control of North Korea's Workers Party and (seem to) support him as the new leader. In the first half of the year, Kim Jong-un will take advantage of the celebrations surrounding Kim Jong-il's birthday (16 February), the 100th anniversary of the country's Great Leader Kim Il-sung (April 15) and the 80th anniversary of the Korean People's Army (25 April) to strengthen internal support for his leadership. For the time being, therefore, it seems it is business as usual.

2012: election year

This year, both parliamentary (in April) and presidential elections (in December) will be held in South Korea. The run-up to these elections will dominate the political discussion. The ruling Grand National Party (GNP) has been characterised by infighting. The implementation of reforms was hampered as a result. In the run-up to the presidential elections, the differences between the two factions will become more pronounced. The party is currently in a process of soul-searching after numerous scandals, among which a vote-buying scandal and a hacking scandal, have forced many of the party's top leadership to quit in recent months. The scandals and the fact that the GNP has failed to adequately address socio-economic issues and unemployment, will likely result in the GNP losing its majority in the coming parliamentary elections. This will add to President Lee's difficulties in carrying out his economic reform agenda during the final months of his presidency.

South Korea							
Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
<i>Key country risk indicators</i>							
GDP (% real change pa)	5.1	2.3	0.3	6.2	3.3	3.5	4.4
Consumer prices (average % change pa)	2.5	4.7	2.8	2.9	4.0	2.5	3.0
Current account balance (% of GDP)	2.1	0.3	3.9	2.8	2.4	1.3	0.6
Total foreign exchange reserves (mln USD)	262150	201144	269933	291491	320000	335000	340410
<i>Economic growth</i>							
GDP (% real change pa)	5.1	2.3	0.3	6.2	3.3	3.5	4.4
Gross fixed investment (% real change pa)	4.2	-1.9	-1.0	7.0	-1.7	1.3	7.2
Private consumption (real % change pa)	5.1	1.3	0.0	4.1	2.5	3.3	3.4
Government consumption (% real change pa)	5.4	4.3	5.6	3.0	2.5	3.4	2.5
Exports of G&S (% real change pa)	12.6	6.6	-1.2	14.5	10.2	5.1	7.2
Imports of G&S (% real change pa)	11.7	4.4	-8.0	16.9	7.7	4.3	7.7
<i>Economic policy</i>							
Budget balance (% of GDP)	3.8	1.5	-1.7	1.4	2.1	1.1	1.1
Public debt (% of GDP)	27	24	23	23	23	23	23
Money market interest rate (%)	4.8	4.8	2.0	2.2	3.1	2.8	3.0
M2 growth (% change pa)	0	16	12	15	3	6	6
Consumer prices (average % change pa)	2.5	4.7	2.8	2.9	4.0	2.5	3.0
Exchange rate LCU to USD (average)	929.3	1102.0	1276.9	1156.1	1105.7	1125.9	1111.2
Recorded unemployment (%)	3.3	3.2	3.7	3.7	3.4	3.5	3.3
<i>Balance of payments (mln USD)</i>							
Current account balance	21770	3196	32790	28213	26218	13950	7340
Trade balance	37177	5173	37863	41877	32667	19370	5460
Export value of goods	389646	434699	358217	464300	559851	579940	624140
Import value of goods	352469	429525	320356	422425	527184	560580	618680
Services balance	-12015	-5739	-6636	-11201	-5386	-7240	-3650
Income balance	135	4434	2278	769	2439	5360	9310
Transfer balance	-3527	-673	-711	-3231	-3502	-3540	-3780
Net direct investment flows	-17935	-16940	-14948	-19380	-17466	-19290	-19910
Net portfolio investment flows	-30615	-25176	39616	30543	544	-9460	-11800
Net debt flows	113196	-5403	-5777	-5272	35625	13610	37300
Other capital flows (negative is flight)	-63148	-16681	17112	-12546	-16411	16180	-7520
Change in international reserves	23268	-61005	68792	21559	28510	15000	5410
<i>External position (mln USD)</i>							
Total foreign debt	379993	381178	370293	361533	401689	407970	443430
Short-term debt	160249	149894	149195	134993	158088	159360	179650
Total debt service due, incl. short-term debt	153307	209628	195779	189859	177293	202450	205260
Total foreign exchange reserves	262150	201144	269933	291491	320000	335000	340410
International investment position	-229538	-58445	-104914	-137318	n.a.	n.a.	n.a.
Total assets	596793	489468	625878	694046	n.a.	n.a.	n.a.
Total liabilities	826331	547913	730792	831364	n.a.	n.a.	n.a.
<i>Key ratios for balance of payments, external solvency and external liquidity</i>							
Trade balance (% of GDP)	3.5	0.6	4.5	4.1	3.0	1.7	0.5
Current account balance (% of GDP)	2.1	0.3	3.9	2.8	2.4	1.3	0.6
Inward FDI (% of GDP)	0.2	0.4	0.3	0.0	0.3	0.3	0.4
Foreign debt (% of GDP)	36	41	44	36	37	37	37
Foreign debt (% of XGSIT)	77	68	81	63	59	58	58
International investment position (% of GDP)	-21.9	-6.3	-12.6	-13.5	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	31	37	43	33	26	29	27
Interest service ratio incl. arrears (% of XGSIT)	3	3	2	1	1	1	1
FX-reserves import cover (months)	7.2	4.6	8.1	6.8	6.1	6.1	5.6
FX-reserves debt service cover (%)	171	96	138	154	180	165	166
Liquidity ratio	133	114	129	127	130	125	124

Source: EIU

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