



Summary

South Korea's export oriented economy is weathering the global economic slowdown relatively well. Real GDP growth will slow to an estimated 2.8% in 2012, down from 3.6% in 2011. Economic policy continues to focus on stability rather than supporting growth. Although inflation has decreased to 1.2% yoy in August, monetary policies have been relaxed only slightly. Export growth will slow in 2012, but the trade balance and current account will remain in the black. The external position and liquidity are sound. Park Guen-hye of the Saenuri Party, the daughter of former dictator Park, leads most polls for December's presidential elections. Relations with North Korea remain muted, but its new leader has, so far, not taken steps that increase risks for South Korea.

Things to watch:

- Developments in North Korea
- Elections and political developments
- Export demand/global economic developments

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South Korea			
National facts		Social and governance indicators rank / total	
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)	31 / 179
Population (millions)	49.4	Corruption perceptions index (rank)	43 / 183
Main languages	Korean	Press freedom index (rank)	44 / 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 2011	
Head of Government (prime-minister)	Kim Hwang-sik	<i>Main export partners (%)</i>	<i>Main import partners (%)</i>
Monetary unit	South Korean won (KRW)	China 24	China 17
		US 10	Japan 13
		Japan 7	US 9
		Hong Kong 6	Germany 3
Economy 2011		Main export products (%)	
<i>Economic size</i>	<i>bn USD</i> % world total	<i>Main import products (%)</i>	
Nominal GDP	1116 1.61	Information & communication products	13
Nominal GDP at PPP	1501 1.89	Semiconductors	10
Export value of goods and services	648 2.94	Chemicals	10
IMF quotient (in mln SDR)	2927 1.35	Machinery & equipment	9
<i>Economic structure</i>	2011 5-year av.	<i>Main import products (%)</i>	
Real GDP growth	3.6 3.8	Crude petroleum	18
Agriculture (% of GDP)	3 3	Machinery & equipment	12
Industry (% of GDP)	39 37	Chemicals	9
Services (% of GDP)	48 49	Semiconductors	8
<i>Standards of living</i>	USD % world av.	<i>Openness of the economy</i>	
Nominal GDP per head	22433 208	Export value of G&S (% of GDP)	58
Nominal GDP per head at PPP	30167 243	Import value of G&S (% of GDP)	56
Real GDP per head	21225 261	Inward FDI (% of GDP)	0.42

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

Economic structure and growth

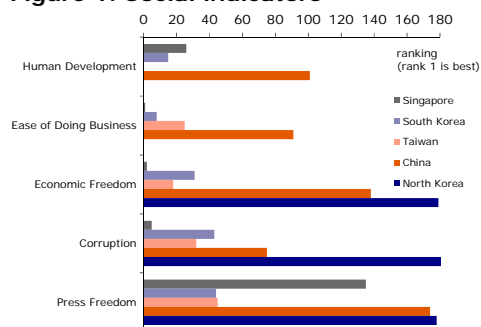
Following rapid, export-led growth in the second half of the 20th century, South Korea developed into a high-income country with a strong industrial base. At USD 1,116bn in 2011, South Korea is the 15th largest economy in the world and a member of the G20 and the OECD. With a population of nearly 50 million, South Koreans earn a comfortable USD 22,433 per person per year (USD 31,167 in PPP terms). Since South Korea adopted an outward-looking strategy in which growth and development were supported by labor-intensive manufactured exports, the country industrialized rapidly and the industrial sector remains the backbone of the South Korean economy. South Korea's shipbuilding and automotive industries have been at the heart of the country's economic success. From the 1990's onwards, South Korea's manufacturing sector expanded into other, more high-tech areas such as microelectronics and microbiology. Meanwhile, the agricultural sector, which accounts for 3 percent of GDP, is protected as it is too inefficient to compete internationally. South Korea needs to import food to feed its population. Diseases such as foot and mouth disease and the bird flu plague the sector from time to time. The high importance of the export sector to the South Korean economy increases the country's vulnerability to adverse external developments.

Growth was exceptionally strong in 2010, as the South Korean economy recovered from the global financial crisis induced slowdown in 2009. Growth fell back to 3.6% in 2011 and is expected to slow further this year to an estimated 2.8%. This year's slowdown is due to slowing external demand, which, in turn, is the result of disappointing demand from the EU, as well from South Korea's main



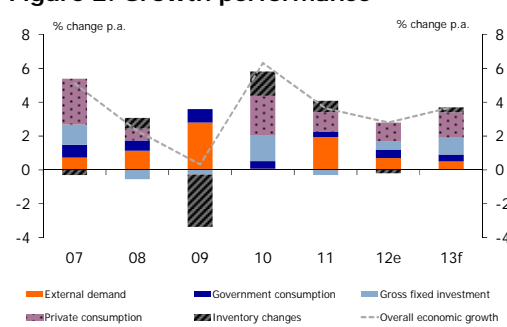
trade partners, the US and China. In addition, private consumption growth slowed somewhat in the first half of 2012, but domestic demand is holding up relatively well nonetheless on the back of government consumption growth and will remain an important growth driver. Next year, we expect growth to recover to around 3.7%, if the external environment improves, which would then also translate into increased confidence among both local and foreign investors. In spite of the economic slowdown, the negative effect on employment is rather limited.

Figure 1: Social indicators



Source: See factsheet

Figure 2: Growth performance



Source: EIU

The government has been tightening regulation in order to reduce vulnerabilities in the banking sector. Banks in South Korea will have to meet Basel III standards by 2015 and loan-to-deposit ratios have decreased from 152% end-2007 to 119% today. In addition, the banking system's reliance on off-shore wholesale funding has decreased. As a result, funding and liquidity risks have been reduced, but remain relatively high nonetheless. South Korean households are highly leveraged, with household debt amounting to nearly 80% of GDP, or around 135% of households' disposable income. This presents a key risk to the banking sector, especially as a large part of these loans is used for consumption purposes and the government is implementing measures to reduce household lending. The slowing housing market presents another important risk. NPL ratios are still acceptable, though, at 1.5% in the first quarter of 2012, while the NPL cover ratio stood at around 150% end-2011. The loss absorbing capacity is high due to high capital levels (the system's core tier-1 capital ratio stood at 10.5% end-2011) and loss-reserves. Moreover, government support will be available if needed.

Political and social situation

Following three decades of authoritarian rule after the end of the Korean War, a constitutional change in 1987 laid the foundation for the current stable multi-party democracy with free and fair elections and smooth transitions of power. The president, who is directly elected for a five-year term, has a strong position and appoints the State Council. The Korean Parliament, or National Assembly (Kuk Hoe), consists of 299 members. South Korea's political and business environment is dominated by close personal relationships and a strong influence of cheabols (large business conglomerates). The downside of this is economic nationalism and corruption.

The landslide victory of the Grand National Party's (GNP, now known as the Saenuri Party, SP) presidential candidate Lee Myung-bak, the former chairman of Hyundai Construction, in the December 2007 elections and an overwhelming victory of the GNP in the 2008 legislative elections put the party back in power in 2008, after 10 years of opposition. In 2011, the GNP lost public support following a number of corruption scandals and the perception that president Lee failed to deliver on his promises. Late last year, Park Guen-hye, the daughter of former dictator Park, was



elected as head of the party and assigned the task of rebranding the party in order to regain public confidence. She renamed the party to the Saenuri (New Frontier) Party and held a strong campaign that stressed the party's policy shift to the left. Against expectations, the party was able to hold on to its majority in parliament after April's parliamentary elections as a result. In August, Park Guen-hye was elected as her party's presidential candidate for the presidential elections that are scheduled to December this year and is leading in the polls.

Since fighting between North and South Korea ceased in 1953 without a formal peace-treaty, the tense and uneasy relationship between the two nations remains an important downside risk. Tensions flare up from time to time, usually due provocations initiated by the North Korean regime, which North Korea claims are a response to actions by South Korea. The continuation of North Korea's nuclear arms program is a particular source of concern for South Korea. Uncertainty increased following the death of North Korea's leader, Kim Jong-il in December last year. His son Kim Jong-un succeeded his father and has since become known as the "Great Successor". The death of Kim Jong-il led to increased uncertainty, as Kim Jong-un is young at around 30 years old, inexperienced and would have to assure his position as top leader. This raised fears of a domestic political power struggle that could lead to increased aggression towards South Korea. On the other hand, steps towards re-unification would also pose a major challenge to the South Korean economy. However, so far, these fears have not been realised. Kim Jong-un has been able to solidify his position with the help of his uncle, Jang Song-taek. Although highly opaque, his policies seem to be aimed towards allowing more freedom, rather than less and towards economically developing the country and opening up its economy. In this respect, the headway made is rather minimal, but seemingly moving in the right direction. His regime is approaching China in particular to help the development of special economic zones. Aggression and expressions thereof, towards South Korea have decreased strongly since Kim Jong-un took over the highest military position. He changed the policy of "military first" and instead aims to use the military for the country's development, thereby straying from the focus on war and security that previously prevailed. We stress that North Korea remains unpredictable and that the positive development could turn quickly. However, the situation seems to have improved rather than worsened and although still tense, the relationship between North and South Korea has not deteriorated. After the presidential elections in South Korea, the dialogue between North and South Korea could improve under a new South Korean president.

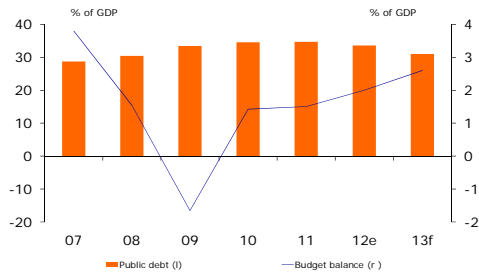
The pro-business policies have worked well, as South Korea takes 15th out of 187 countries on the Human Development index and 8th out of 183 countries on the ease of doing business index while other rankings are relatively sound as well. Furthermore, healthcare and education have improved, indicated by an increase of life expectancy at birth from 54 years in 1960 to 79 years today, and secondary and tertiary school enrolment increasing from 54% and 8% respectively in 1975 to nearly 100% today.

Economic policy

In the medium-term, South Korea will continue to pursue business-friendly policies, although the implementation of reforms is likely to continue to suffer delays due to political infighting. South Korea's fiscal position is strong. The government normally runs a budget surplus of between one and two percent, partly supported by surpluses of the country's social security fund, which includes the national pension fund. This year, the budget surplus is estimated to increase to 2% of GDP, up from 1.5% of GDP in 2011. As a result, public debt is relatively low at around 35%. Nearly all of South Korea's public debt is denominated in won.

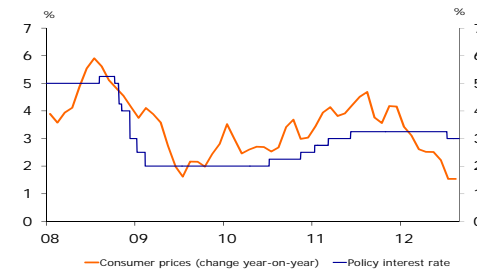


Figure 3: Public finances



Source: EIU

Figure 4: Policy rate and inflation



Source: Reuters EcoWin

Monetary policies are conducted by the Bank of Korea (BoK) based on an inflation targeting regime since 1998. In spite of the growth slowdown, the BoK has largely maintained a pro-stability policy stance, favoring stability as it did in the past years, and has only lowered the policy interest rate once by 25bps to 3%. The central bank is genuinely concerned about inflation picking up again on the back of increased public spending and a potential improvement of the external environment. However, with inflation having fallen to only 1.2% year-on-year in August 2012, well below the central bank's target rate of 3% ±1%, more rates cut are likely against a backdrop of slowing growth.

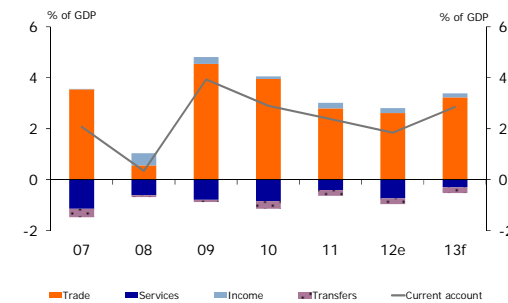
The South Korean won officially floats freely, but authorities are intervening from time to time. When the won appreciates too much for comfort, the central bank intervenes to assure export competitiveness is maintained. The increase of FX-reserves in 2011 reflects these interventions. However, with export growth slowing this year, the won is depreciating less than could be expected, as authorities aim to limit the movement of the currency. This signals that authorities are also still concerned about imported inflation, partly due to still elevated fuel prices and rising food prices.

Figure 7: Exchange rate



Source: Reuters EcoWin

Figure 8: Current account



Source: EIU

Balance of Payments

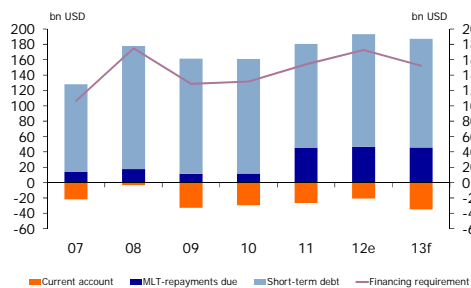
As a highly diversified and internationally competitive export economy, South Korea's current account has been in surplus since 1997. The trade balance is the foundation under the current account surplus, as it has been in surplus since 1996 and is well diversified, except for perhaps the need for oil imports (18% of total imports). In 2011, the trade balance showed a surplus of 2.8% of GDP. As lower export growth also implies less need to import inputs for the export sector, the deterioration of the trade balance is limited in 2012, with an expected trade surplus of 2.6% of GDP, in spite of the decreased external demand. The surpluses on the trade and income balances



more than make up for the deficits on the services and current transfers balances, resulting in a current account surplus of 2.4% of GDP in 2011 and an estimated 1.8% of GDP in 2012.

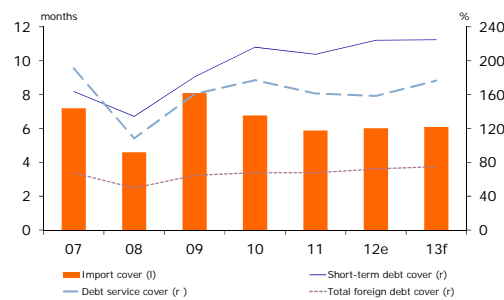
Foreign direct investment inflows are suboptimal. Although, at the moment, the weak global environment is partly to blame, the fact that South Korea is a difficult country to invest in due to its antipathy towards foreign ownership is a more persistent problem. In 2011, FDI inflows amounted to 0.4% of GDP, partly due to investments coming in from China. On a net basis, there is an FDI outflow. Portfolio flows are large and can be highly volatile, due to South Korea's open relatively open financial account, with an important share of South Korean equities and bonds in foreign hands, and highly developed capital markets. Large swings in foreign holdings can occur irrespective of domestic developments. Adverse external developments are known to trigger potentially large portfolio outflows, as investors worldwide become more risk averse. In order to be able to absorb such volatile capital flows, and thus avoid an Asian Crisis scenario, South Korea has been building up FX-reserves. In 2011, FX-reserves increased by USD 14.8bn, bringing the total to USD 304bn by the end of last year. This year, FX-reserves are expected to increase by around USD 13bn to a total of USD 317bn.

Figure 9: Financing requirement



Source: EIU

Figure 10: External liquidity



Source: Covers offered by official FX-reserves, EIU

External position

South Korea's external debt position is strong. Total foreign debt amounts to around 40% of GDP and around 65% of total current account receipts. Short-term foreign debt amounts to about one-third of total foreign debt. As a result of South Korea's large amount of FX-reserves, external liquidity is sound. FX-reserves cover about 6 months of imports and the country's liquidity ratio stood at a comfortable 127% in 2011 while a slight decline to 125% is expected for this year.



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	6.3	3.6	2.8	3.7
Consumer prices (average % change pa)	2.5	4.7	2.8	2.9	4.0	2.4	2.9
Current account balance (% of GDP)	2.1	0.3	3.9	2.9	2.4	1.8	2.9
Total foreign exchange reserves (mln USD)	262150	201144	269933	291491	304255	317000	342600
<i>Economic growth</i>							
GDP (% real change pa)	5.1	2.3	0.3	6.3	3.6	2.8	3.7
Gross fixed investment (% real change pa)	4.2	-1.9	-1.0	5.8	-1.1	2.0	3.8
Private consumption (real % change pa)	5.1	1.3	0.0	4.4	2.3	2.1	3.0
Government consumption (% real change pa)	5.4	4.3	5.6	2.9	2.1	3.6	3.0
Exports of G&S (% real change pa)	12.6	6.6	-1.2	14.7	9.5	3.8	5.3
Imports of G&S (% real change pa)	11.7	4.4	-8.0	17.3	6.5	2.8	5.3
<i>Economic policy</i>							
Budget balance (% of GDP)	3.8	1.5	-1.7	1.4	1.5	2.0	2.6
Public debt (% of GDP)	29	30	33	35	35	34	31
Money market interest rate (%)	4.8	4.8	2.0	2.2	3.1	3.1	3.2
M2 growth (% change pa)	0.3	16	12	15	9	6	6
Consumer prices (average % change pa)	2.5	4.7	2.8	2.9	4.0	2.4	2.9
Exchange rate LCU to USD (average)	929.3	1102.0	1276.9	1156.1	1108.3	1132.5	1100.5
Recorded unemployment (%)	3.3	3.2	3.7	3.7	3.4	3.8	3.3
<i>Balance of payments (mln USD)</i>							
Current account balance	21770	3196	32790	29394	26505	20740	34980
Trade balance	37177	5173	37863	40054	31152	29430	39580
Export value of goods	389646	434699	358217	461459	552795	558770	606050
Import value of goods	352469	429525	320356	421404	521643	529340	566470
Services balance	-12015	-5739	-6636	-8598	-4580	-8340	-3740
Income balance	135	4434	2278	1015	2455	2200	1920
Transfer balance	-3527	-673	-711	-3078	-2524	-2550	-2770
Net direct investment flows	-17935	-16940	-14948	-22184	-15695	-20370	-22140
Net portfolio investment flows	-30615	-25176	39616	35309	-1424	-11420	-13770
Net debt flows	121264	10139	18420	17044	13551	-2040	20640
Other capital flows (negative is flight)	-71216	-32224	-7086	-38005	-8086	25880	5790
Change in international reserves	23268	-61005	68792	21559	14851	12780	25500
<i>External position (mln USD)</i>							
Total foreign debt	388237	404996	417511	430305	449645	438760	457800
Short-term debt	160249	149894	149195	134993	146610	141390	152530
Total debt service due, incl. short-term debt	137335	185897	168084	164774	188713	200250	194140
Total foreign exchange reserves	262150	201144	269933	291491	304255	317000	342600
International investment position	-229538	-58445	n.a.	n.a.	n.a.	n.a.	n.a.
Total assets	596793	489468	n.a.	n.a.	n.a.	n.a.	n.a.
Total liabilities	826331	547913	n.a.	n.a.	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	3.9	2.8	2.6	3.2
Current account balance (% of GDP)	2.1	0.3	3.9	2.9	2.4	1.8	2.9
Inward FDI (% of GDP)	0.2	0.4	0.3	0.1	0.4	0.5	0.6
Foreign debt (% of GDP)	37	43	50	42	40	39	37
Foreign debt (% of XGSIT)	79	72	91	74	66	64	61
International investment position (% of GDP)	-21.9	-6.3	n.a.	n.a.	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	28	33	37	28	28	29	26
Interest service ratio incl. arrears (% of XGSIT)	2	1	1	1	1	1	1
FX-reserves import cover (months)	7.2	4.6	8.1	6.8	5.9	6.0	6.1
FX-reserves debt service cover (%)	191	108	161	177	161	158	176
Liquidity ratio	135	116	135	132	127	125	130

Source: EIU

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