

# RATING PERSPECTIVE

## Republic of Korea

### Korean Economy Hard Hit by Global Financial and Economic Crisis

#### Preface

JCR on February 27, 2009 affirmed its ratings on the foreign currency and local currency long-term senior debts of the Republic of Korea and simultaneously lowered their outlook from stable to negative. The ratings reflect the government's relatively strong fiscal position, the country's highly advanced and diversified export industries and its economic development driven by those export industries. On the other hand, the ratings are constrained mainly by the country's deteriorating foreign currency liquidity position, the vulnerability of Korean banks' funding structure that has come to the fore over their foreign currency liquidity problems and the North Korea issue. The revision of the rating outlook reflects JCR's view of the Korean economy as stated below.

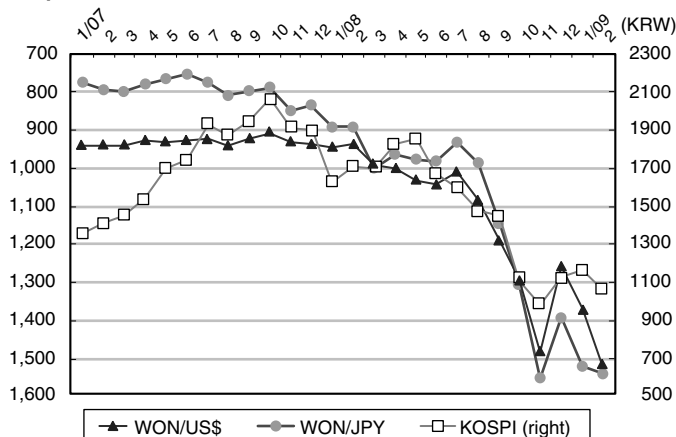
Korea's real GDP growth rate decelerated to minus 3.6% (y-o-y) in the fourth quarter of 2008 from plus 3.8% in the previous quarter on a steep contraction of domestic demand. Up until the first half of 2008, strong external demands had driven the Korean economy. The steady growth of export contributed to the employment stability and thereby the sustained private consumption. However, the exports took a turn for contraction in the fourth quarter of 2008 as the impact of global financial crisis spread across the world economy at a much higher speed and on a larger scale than expected. In the United State, a long-time driving force of the world economy, the household sector, being hit by the collapse of housing bubbles, may move to a higher savings ratio. Should this happen, the private consumption may stay

slumped for a prolonged period, which is a dire situation unobserved in recent years. The European economy may also run into a deep recession following the burst of its housing bubbles. In the absence of a driving force, the world economy will remain depressed over a long period. Against such backgrounds, Korea's real GDP growth rate is expected to fall to a minus 3-4% in 2009 from a plus 2.6% in 2008, even with the effects of the government's stimulus package being considered. How fast the Korean economy can pick up after 2010 will depend on recovery of the world economy, particularly the U.S. economy and a resultant rebound of the world trade. The massive fiscal measures being taken by the U.S. and European governments are essential to prevent the economies from falling into the most critical situation. However, it is hard to expect those measures to be effective enough to ignite a jump-start of V-shaped recovery. Therefore, the possibility of the world economy remaining sluggish for long cannot be ruled out. The slump of the Korean economy may also be prolonged. JCR will keep a close watch on the development of world economies, in particular, the U.S. economy and its impact on the Korean economy.

#### Macroeconomic trends

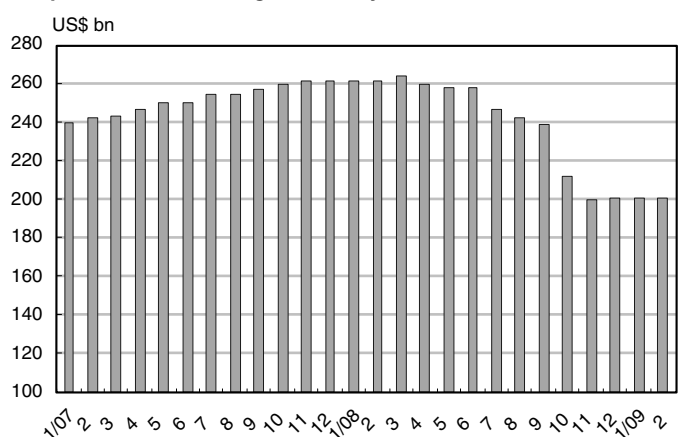
Hit by the impact of global financial crisis, the Korean economy suffered a flight of foreign capital in the second half of 2008, touching off an endless slide of stock prices and the won (Graph 1). The foreign currency reserves excluding gold, SDR and IMF reserve position fell to US\$199.8 billion in November 2008 from their peak of US\$263.8 billion in

Graph 1. Trend of FX and Stock Price



Sources: BOK, KRX

Graph 2. Trend of Foreign Currency Reserves



Source: BOK

March 2008, which reminded the market of a recurrence of the 1997 Asian currency crisis. However, thanks to its currency swap agreements with the monetary authorities of Japan, the United States and China, Korea prevented its foreign liquidity problem from developing into a crisis. Later, the reserves turned to a moderate increase, recovering to US\$200.8 billion at the end of February 2009 (Graph 2).

However, statistics for the fourth quarter of 2008, as announced right after the worst influences of global financial crisis appeared to have gone, revealed a severe deterioration of the country's real economy. The real GDP growth rate for the quarter turned out to be a minus 3.6% (y-o-y) as compared to a plus 3.8% in the previous quarter, dramatic downturn on a sharp decrease of domestic demands. This meant a 20.9% annualized contraction on a quarter to quarter basis.

Strong external demands and solid private consumption had driven the Korean economy till the first half of 2008. The latter had been supported by the stable employment amid steady growth of exports. However, as the global financial upheavals began to bite at a much higher speed and on a larger scale than expected, exports started shrinking in the fourth quarter. The growth of new employment also began slowing down in the same period, registering a net decrease in December (Graphs 3 and 4).

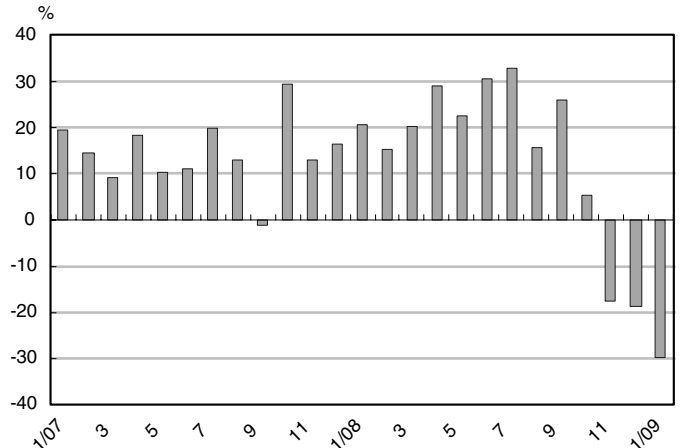
In the United States, private consumption may stay slumped for a prolonged period, a situation not seen in recent years, due to the burst of housing bubbles. Hence, the U.S. economy is likely to fall into a dire situation. The European economy may also run into a deep recession for similar reasons. In absence of a driving force, the world economy may remain depressed longer than expected. Against such backgrounds, Korea's real GDP growth rate is expected to fall to a minus 3-4 % in 2009 from a plus 2.6% in 2008, even after considering the effects of the government's stimulus package. Depending on the development of world economies, the possibility of the Korean economy remaining sluggish after 2010 cannot be ruled out (Graph 5).

**The trends of the world economy centering on the U.S. economy**

The world economy had maintained a rapid growth, mainly driven by the U.S. economy until recently. However, its growth rate decelerated to 3.4% in 2008 from 5.2% in 2007 as the industrialized economies slowed down amid the financial woes that surfaced in the United States and Europe. According to the IMF economic forecast announced on January 28, 2009, the world economic growth rate is projected to slip further to 0.5% in 2009, the lowest since the end of World War II.

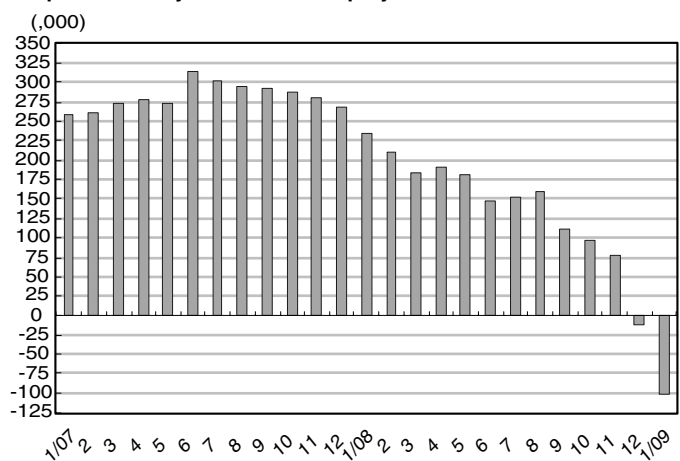
Following the bust of the residential bubbles, the U.S. household sector may seek to expand savings in a move to make up for the lost value of residential property, which has been the substitute for savings. As a result, private consumption demand will retreat to the extent the savings ratio rises.

**Graph 3. Trend of Goods Exports (y-o-y)**



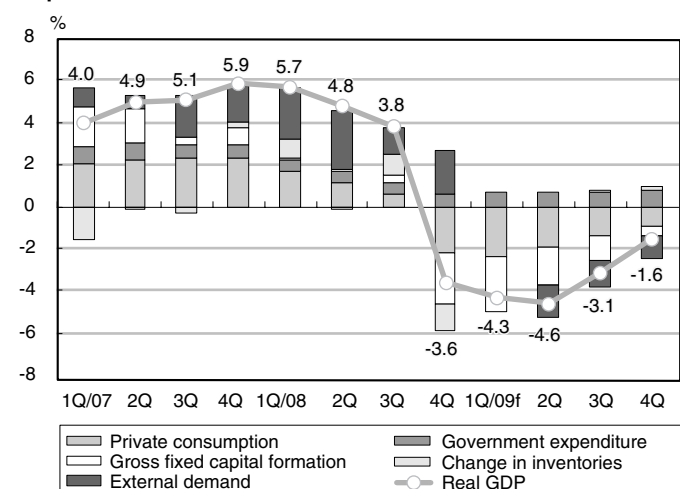
Source: BOK

**Graph 4. Monthly Increase of Employment**



Source: Korea Statistical Information Service (KOSIS)

**Graph 5. Contribution to Real GDP Growth**



Source: BOK. JCR's forecast

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Such change in the attitude of U.S. households may persist until they complete repairing their balance sheet. It is hard to expect this process to end in a short period of one or two years. Therefore, the U.S. government may need to fill the structural deflationary gap in the macro economy with increased fiscal expenditures for a significantly long period of time. Also, due to the impact of a steep credit contraction caused by the paralyzed financial system, the U.S. economic growth rate may inevitably decelerate to a minus 1.5-2.0% in 2009 even after considering the effects of the government's massive fiscal stimulus package. In 2010, the U.S. economy may dodge a further deterioration and head for a moderate recovery thanks to the effects of the fiscal stimuli. It is more

likely, however, there will be no nominal growth and there may only be a 1.0% real GDP growth brought by a 1.0% deflation rate, a situation where no people can really feel a business recovery (Graphs 7 and 8).

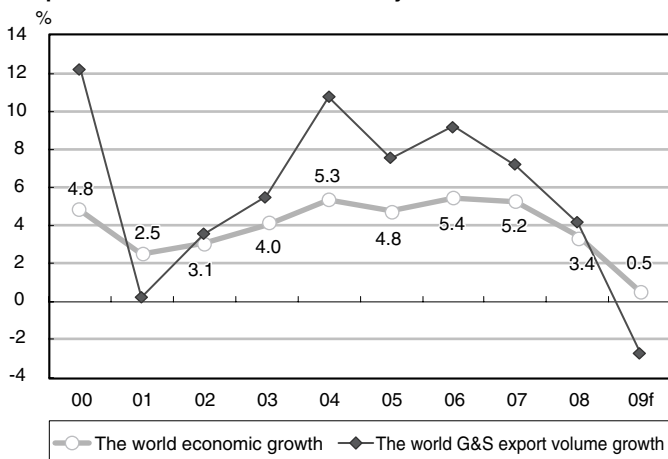
With the impact of global financial crisis spreading deeper into the world real economy, the world economic growth rate in 2009 may prove to be lower than the IMF projection, possibly falling into a negative growth. The European economy may also fall into a severe recession. Future developments need to be closely watched.

### Public finance and financial system

Despite the public fund injection during the financial system reforms after the 1997 economic crisis, Korea's public debt has been maintained at manageable levels owing to its conservative fiscal management in the past. The general government public debt/GDP ratio had been on the rise till 2006 due to the procurement of funds for foreign exchange market stabilization as well as the issuance of public housing bonds. However, the ratio stood relatively lower at 33.2% at the end of 2007, indicating that the country's fiscal position has been kept generally sound. The Korean government retains fiscal flexibility to increase its budget spending for economic stimulus. This is one of the important factors that support the country's credit ratings. In January 2009, the government announced its "Green New Deal" totaling 50 trillion won aimed to create 950,000 jobs in four years. The amount includes the 35 trillion won fiscal package which the government unveiled in November 2008. It is hoped that these fiscal measures will be implemented without a hitch. JCR will monitor how effective they prove to be.

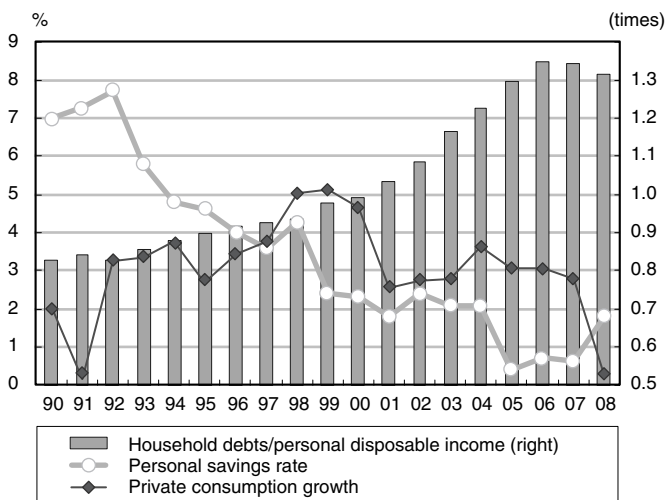
The country's financial system restored soundness thanks

Graph 6. Trend of The World Economy and World Trade Volume



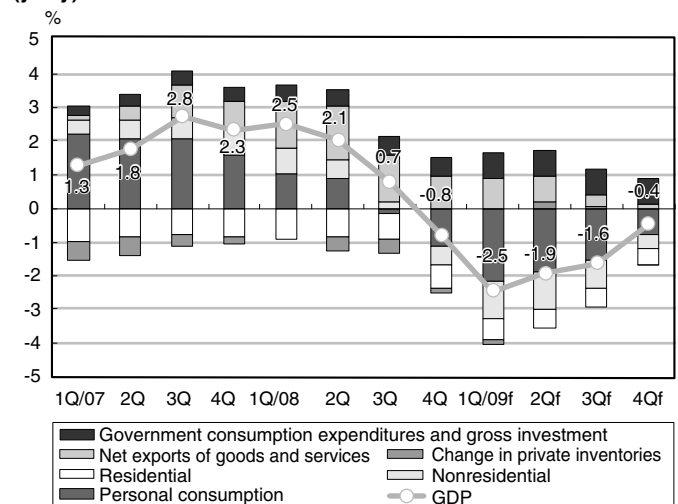
Source: IMF

Graph 7. The U. S. Economy - Trend of Private Consumption



Sources: The U.S. Federal Reserve, BEA (Ministry of Commerce)

Graph 8. The U.S. Economy - Contribution to Real GDP Growth (y-o-y)



Source: BEA (Ministry of Commerce). JCR's forecast

to the effect of structural reforms carried out after the Asian currency crisis. In recent years, however, the banking sector's loan/deposit ratio has been deteriorating amid the intensified competition. This requires Korean banks to improve their funding structure. In addition, their liquidity problems surfaced in the second half of 2008. Hence their foreign currency liquidity positions need to be closely watched. Meanwhile, the nonperforming loan ratio at commercial banks (covering those below substandard loans) declined to 0.72% at the end of 2007 from 12.9% in 1999 right after the Asian currency crisis. And again, the ratio turned upward amid the economic downturn in 2008, standing at 1.11% at the end of the year. The ratio may further rise if the economy worsens. The capital adequacy ratio on a BIS basis stood at 12.19% (Tier I ratio: 8.79%) at the end of 2008 (Graph 10).

**External balance**

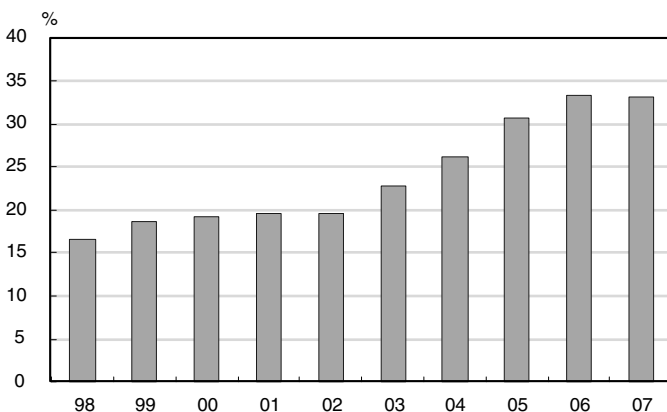
Korea had been posting annual current account surpluses until 2006. It slipped into deficit, however, in 2007 and 2008 on increased service account deficits and a rapid expansion of imports caused by higher oil prices. The country is likely to maintain surpluses after 2009 on an increased trade surplus brought by lower oil prices and reduced imports reflecting weakened domestic demands. The foreign exchange reserves had kept on swelling until 2006 on the continued current account surplus and a subsequent increase in foreign capital inflows. However, the reserves fell drastically toward November 2008 due mainly to increased capital outflows and the Bank of Korea's market intervention to support the won in the second half of the same year. The reserves recovered slightly afterwards to stand at US\$200.8 billion at the end of February 2009. The exchange reserves/

short-term external debt ratio fell to 1.3 fold at the end of 2008 from the peak of 3.5 fold in 2004, as the short-term external debt has swelled in volume. Much of the rise in short-term debts in recent years stemmed from the increased borrowings by foreign banks in Korea from their parents in connection with export-related forward exchange deals and the liabilities incurred as shipbuilders' advance payment for their bottom exports. As such, those liabilities may well be considered less risky than what they appear in the sense that they are backed by an equivalent amount of external assets. However, even after excluding such an increase in the short-term external debt, the country's foreign currency liquidity position has much weakened as compared with its soundest levels in the past like the one seen in 2004. Thanks in part to the effects of the country's currency swap agreements with the monetary authorities of the United States, Japan and China, its liquidity problems have apparently tapered off for now. However, JCR deems it necessary to keep watching the country's liquidity position as it is less likely to improve rapidly in the future.

**Political situation**

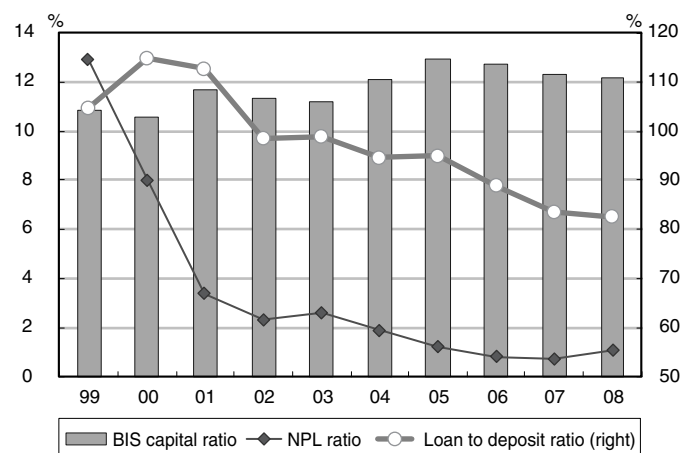
In Korea, after a decade of reformist governments from 1998 to 2007, a conservative government has returned to the office, with the election of December 2007 bringing a former Seoul mayor, Lee Myung-Bak to the presidency. As the ruling Grand National party won the following parliamentary election in April 2008 as well, the national politics appeared to go well-managed. In reality, however, the year 2008 turned out to be quite harsh for the Lee administration. Its support rate went on dwindling rapidly amid the people's strong protest over the resumption of beef imports from the

**Graph 9. General Government Debts to GDP Ratio**



Sources: Ministry of Strategy and Finance, BOK

**Graph 10. Trend of Banks' NPL Ratio and BIS Capital Ratio**



Source: FSS. NPL ratio means standard or below ratio. Loan to deposit ratio for 2008 is as of September 2008.

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U.S., the deterioration of global economies, the upsurge of oil prices, the mounting inflationary pressure and delayed policy response to those problems. After September 2008, as the global financial crisis deepened, the government announced a spate of economic measures. In the coming months, it will be tested how smoothly the government can implement those measures and what effects they may produce.

As P. F. Drucker pointed out, a society that grows more pluralistic than of a simple political confrontation needs not a large government nor a small government, but a government that can produce satisfactory results. He also said that what is required of today's political leader is not charisma but a clear vision that unites a complicated pluralistic society and a practical ability to implement policies. These suggestions seem to be relevant in today's Korean society.

The confrontation between the conservative and the reformist remains deep-rooted in the Korean society, and it may take time for the situation to change. In a sense, however, the country has been experiencing a shift from the age of conservative-reformist feud to a new age more rapidly than other industrialized countries. One can say that Korea now faces a period of political and social changes. To what direction will the country's politics proceed in the future? That direction may be determined to a large extent by the ways in which the Lee administration addresses the nation's historical ordeals caused by the ongoing global recession.

### North Korea issue

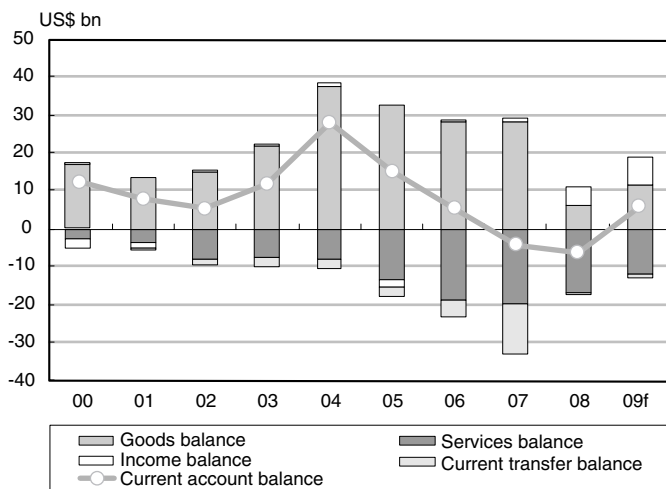
The stalled six-party talks on North Korea's denuclearization were resumed in February 2007 and have produced some results including the adoption of an agreement regard-

ing suspension of the North's nuclear-related facilities in return for energy assistance. The question of lifting the freeze on North Korea-related funds at a Macao bank posed distraction for further progress at the talks, but the issue was finally resolved in June 2007 with the remittance of the money via a Russian bank. Initial steps in North Korea's abandonment of its nuclear program such as suspension of the nuclear facilities were implemented later on. However, the talks ran into an impasse again in the process of moving to second-phase actions including Pyongyang's disclosure of its nuclear programs and disabling of its nuclear facilities.

The situation started moving again after Pyongyang submitted to the United States documents concerning its nuclear development efforts in May 2008. The six-party talks resumed in July that year. Since the United States removed North Korea from its list of terrorism-sponsoring states in October 2008 after 20 years and nine months, the situation appeared to move further. Future developments are hard to predict at this time due in part to leader Kim Jong-Il's health concern as well as the election of Barack Obama as U.S. president.

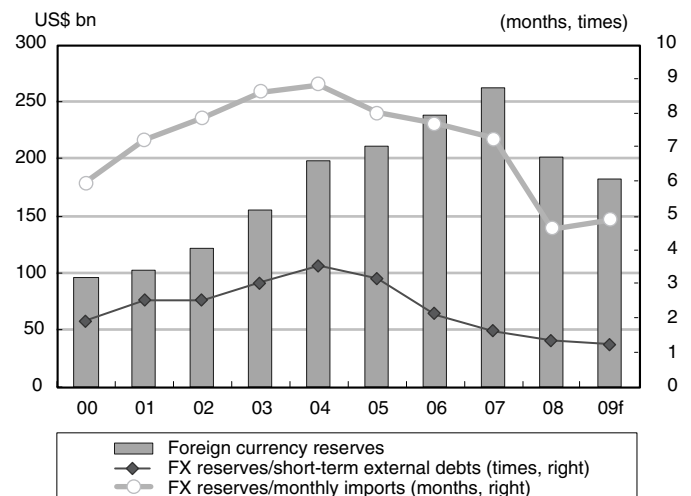
The North Korea issue is likely to become a negative factor for South Korea's future economic development as unification of the divided states could entail risks of fiscal burden for the South. It is necessary to watch future developments of the issue from the viewpoint of the country's credibility assessment. While the six-party talks may have some twists as seen in the past, the framework itself will be maintained despite the persistent presence of tangled national interests. JCR

Graph 11. Trend of Current Account



Source: BOK. JCR's forecast

Graph 12. Trend of Foreign Currency Liquidity Position



Source: BOK. JCR's forecast

**Main Economic Indicators: Republic of Korea**

		2002	2003	2004	2005	2006	2007	2008	2009f
Real GDP Growth Rate	%	7.0	3.1	4.7	4.2	5.0	5.1	2.6	-3.4
CPI	%	2.8	3.5	3.6	2.8	2.2	2.5	4.7	2.9
Unemployment Rate	%	3.3	3.6	3.7	3.7	3.5	3.3	3.2	4.0
Bank Lending Rate (AVG)	%	6.5	6.2	5.9	5.7	6.1	6.6	7.0	6.5
Central Government fiscal deficit/GDP	%	3.3	1.1	0.7	-0.4	0.4	3.8	1.8	-1.5
Public Debt/GDP	%	19.5	22.9	26.1	30.6	33.3	33.2	32.2	35.1
Goods Exports (FOB)	US\$ bn	163	197	258	289.0	331.8	379.0	433.4	370.6
Change	%	7.9	20.7	30.6	12.1	14.8	14.2	14.3	-14.5
Goods Imports (FOB)	US\$ bn	149	175	220	256.3	303.9	350.9	427.4	359.0
Change	%	7.7	18.0	25.6	16.4	18.6	15.4	21.8	-16.0
Trade Balance/GDP	%	2.7	3.6	5.5	4.1	3.1	2.9	0.7	1.6
Current Account Balance/GDP	%	1.0	2.0	4.1	1.9	0.6	-0.4	-0.7	0.8
Foreign Exchange Reserves	US\$ bn	120.8	155	198	210.0	238.4	261.8	200.5	181.3
Import Coverage Ratio	month	7.8	8.6	8.8	8.0	7.7	7.2	4.6	4.9
External Debt/GDP	%	25.9	25.9	25.3	23.7	29.3	39.2	43.2	51.5
External Debt/G&S Exports	%	73.8	68.4	57.5	56.2	68.1	86.0	74.7	83.5
Public External Debt/G&S Exports	%	11.7	7.3	5.5	4.6	5.2	12.1	10.0	11.2
Short-term External Debt/External Debts	%	34.1	32.2	32.7	35.1	43.7	42.1	39.7	38.5
Foreign Exchange Reserves/Short-term external debt	times	2.5	3.0	3.5	3.2	2.1	1.6	1.3	1.3
DSR	%	12.1	12.7	10.6	9.8	7.3	6.9	11.1	12.5

Sources: BOK, KOSIS, MOFE and JCR's forecast