

## Economics Group

### Special Commentary

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## Recent Economic Developments in South Korea

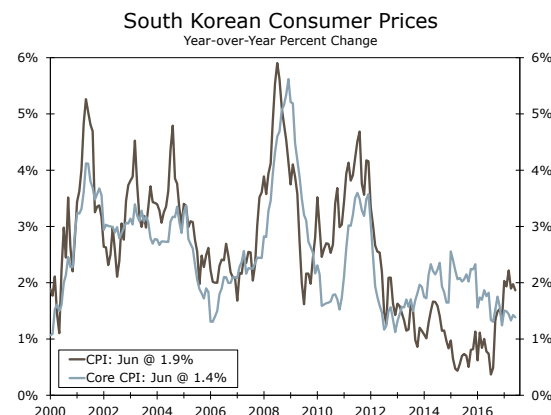
With tensions rising this week between the United States and North Korea, we thought we would take the opportunity to provide readers with an update on the South Korean economy. Measured at current exchange rates, South Korea had the 11<sup>th</sup> largest economy in the world in 2016 with nominal GDP equivalent to \$1.4 trillion. As has been the experience of most economies, South Korea has experienced a slower rate of economic growth in recent years with real GDP growing at an annual average rate of only 2.8 percent between 2012 and 2016. We project that the economic expansion in South Korea will continue for the foreseeable future with real GDP growing 2.9 percent in 2017 and 2.8 percent next year. Of course, a war on the Korean peninsula, should one come to pass, would have profound effects on our growth forecasts.

***We project that the economic expansion in South Korea will continue for the foreseeable future.***

**Figure 1**



**Figure 2**



**Source: IHS Global Insight and Wells Fargo Securities**

Growth in the rest of the world is important for the South Korean economy because real exports of goods and services are equivalent to about 55 percent of GDP. China takes in one-quarter of South Korea's exports, making it South Korea's most important export market by a wide margin. So, economic deceleration in China since the beginning of the decade has exerted a slowing effect on the South Korean economy. However, South Korea has also experienced deceleration in its productive capacity as growth in its working-age population has slowed in recent years. The unemployment rate has trended up from about 3 percent or so in 2014 to its present rate of 3.8 percent, which is high by South Korean standards.

This slow growth environment has depressed rates of CPI inflation in South Korea (Figure 2). Consequently, the Bank of Korea cut its main policy rate from 3.25 percent in mid-2012 to 1.25 percent today. The combination of lower rates in South Korea in conjunction with expectations of higher U.S. rates caused the Korean won to depreciate nearly 20 percent versus the U.S. dollar between mid-2014 and early 2016 (Figure 3). The won has recouped some of its losses over the past year, but it could come under downward pressure again if

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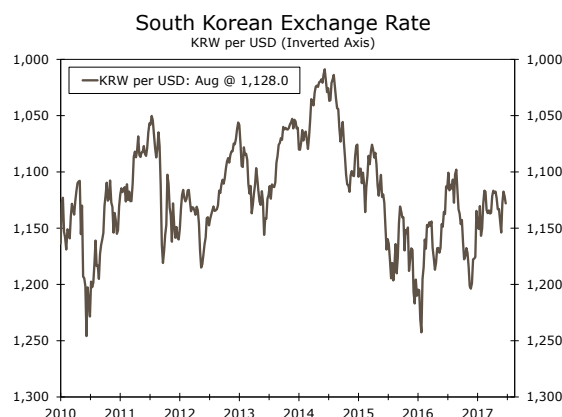


***Clearly, a confrontation with the North represents a clear and immediate downside risk to the South Korean economy.***

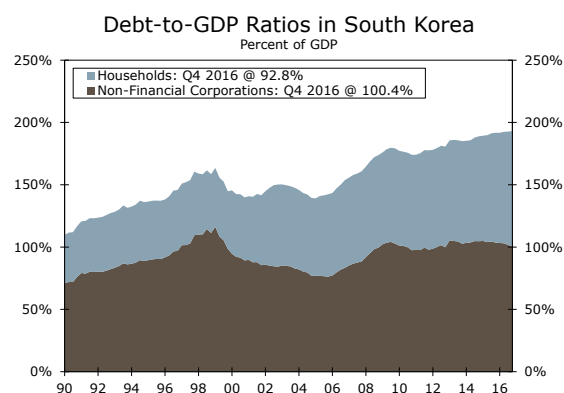
tensions between the United States and North Korea escalate further. Indeed, the won fell versus the greenback this week as tensions rose.

Clearly, a confrontation with the North represents a clear and immediate downside risk to the South Korean economy. A build-up of financial leverage represents a longer-term economic risk. The debt-to-GDP ratio in the non-financial corporate sector peaked ahead of the financial crisis in 1997-1998, and it has been stable on balance subsequently (Figure 4). However, the debt-to-GDP ratio of the household sector has trended up from about 40 percent in the early 1990s to more than 90 percent today. Although we do not look for the central bank to be “jacking up” rates anytime soon, growth in consumer spending could be depressed once a higher interest rate environment finally comes to pass.

**Figure 3**



**Figure 4**



Source: IHS Global Insight, Bank for International Settlements and Wells Fargo Securities

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