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Economics Group

Special Commentary

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Korean Economic Outlook for 2016

More to the Export Story than Just Slower Growth in China

Trade is very important to Korea. In 2014, the last full year for which we have data, exports of goods and services were equivalent to more than 50 percent of GDP. However, in 2015, it appears likely that share will fall below 50 percent for the first time since 2009 and 2010 when world trade dried up in the wake of the global recession. So far in the first 10 months of 2015, exports have been negative every month on a year-over-year basis.

The slowdown in trade is largely attributable to slower growth in China, Korea's top trading partner. That factor will remain a key headwind for Korea in the coming year. However, as we discuss in this report, falling prices for some key Korean exports bear much of the blame; export volumes have been steadier. Also, the broad deterioration in Korean exports masks a growing share of exports headed to Korea's second largest export market, the United States. Continued U.S. economic expansion and expected weakening of the Korean won versus the dollar may prove to be a welcome offset to concerns about the negative effect of Fed tightening on emerging markets.

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Figure 1

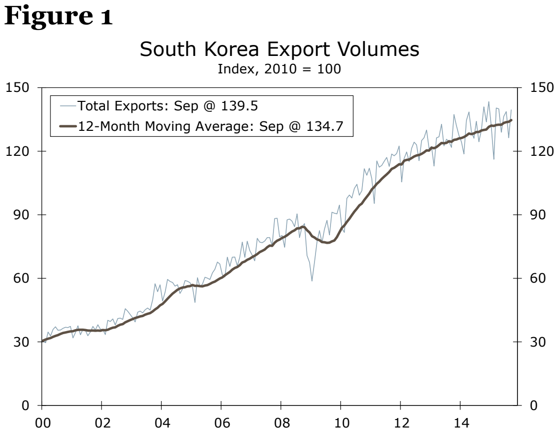
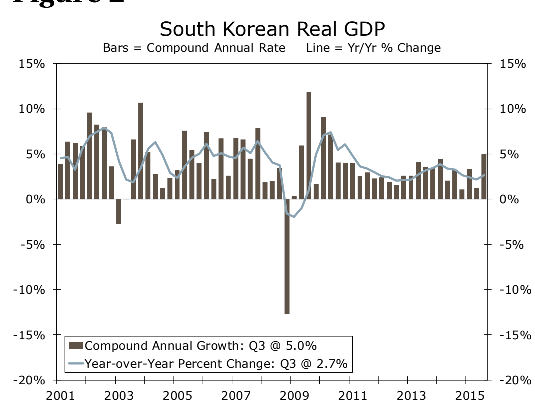


Figure 2



Source: IHS Global Insight and Wells Fargo Securities, LLC

The Bank of Korea's (BoK) rate-setting Monetary Policy Committee (MPC) cut its target lending rate twice this year, taking the base rate to 1.50 percent at present from 2.00 percent at the start of the year. We are of the view that there is little pressure on the BoK to reduce rates more in the near future, especially in light of the somewhat better-than-expected outturn for Q3 GDP and expected firming in prices next year.

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The outbreak of Middle Eastern Respiratory Syndrome (MERS) held back GDP growth in the second quarter, but owing to a swift response from the government, a payback surge lifted third quarter GDP growth to an annualized rate of 5.0 percent. After some moderation in the final quarter of the year we expect full-year GDP growth of 2.5 percent in 2015 before growth firms

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somewhat to a 3.0 percent rate for 2016, a view that is informed partly by a less negative view on exports.

Ties That Bind: No Country Imports More from Korea than China

The trajectory of Korean export growth has been stuck in neutral for at least the past three years. Figure 1 on the first page of this report shows how, aside from the disruption from the global recession in 2009, the value of Korean exports maintained a clear upward trend from 2000 until about 2012 when outgoing trade clearly began to decelerate. What pattern can we see that is negatively impacting trade and what can we expect to see in the year ahead?

China is Korea's largest export market.

The year-over-year rate of GDP growth in China, which had been running at double-digit percent rates in 2010 and 2011, slowed to single-digit territory in 2012 and has been trending down in the years since. China is Korea's largest export market. That is true for a lot of countries; China is the largest export partner for many economies around the world, particularly in Asia. What makes the relationship with Korea unique is that China imports more from Korea than any other country in the world.

After years of having its cart hitched to the right horse, Korea's trade ties to China have not been a big positive in recent years. Our own forecast for Chinese GDP growth anticipates continued moderation in the growth rate. On that basis and in the context of prospects for continued slow growth in global trade more broadly, there is little reason to anticipate a swift turnaround in prospects for Korean exports.

Some Non-China Factors Influencing Exports

Taken together, the three largest categories of goods exports comprise more than a quarter of all exports and all have been under significant price pressure.

Having acknowledged the widely accepted role of China's slowdown in Korea's export woes, we think there are a few other aspects to Korean trade that sometimes go overlooked. Korea is internationally recognized for its high-tech and semiconductor sector as well as its auto industry, which has grown rapidly over the past two decades. Korea is also a major oil refiner. It imports crude oil and exports products derived from oil. Refined petroleum exports actually comprise a slightly larger share of exports than automobiles for Korea.

Taken together, the three largest categories of goods exports (integrated circuits, refined petroleum and automobiles) comprise more than a quarter of all exports. What do the three of these products have in common? All have been under significant price pressure. Oil prices have been more than halved since June 2014. According to the Korean producer price index, electronical and electronic equipment prices are down 3.3 percent over the past year and prices for manufacturing industry products are off 7.6 percent.

Figure 3

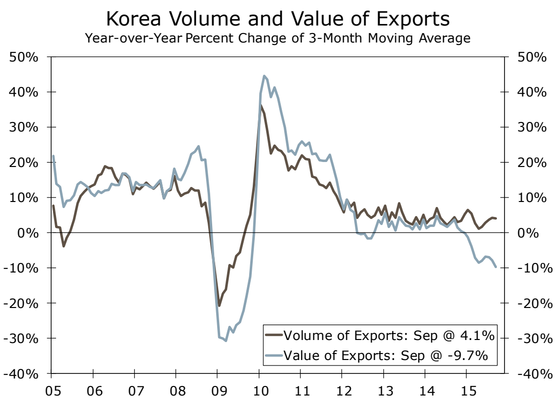
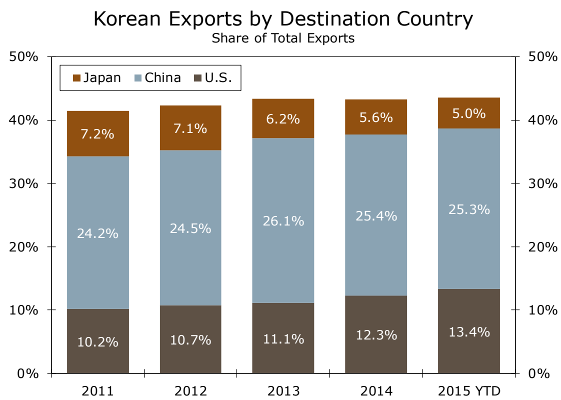


Figure 4



Source: IHS Global Insight and Wells Fargo Securities, LLC

The point is that prices are playing a role in export weakness. In Figure 3, we plot the growth trajectory for Korean exports in volume terms and in value terms. While exports look exceptionally weak in value terms, the tepid growth rate for the volume growth in exports does not look meaningfully different from any other time in the past three years or so. After such steep price declines in the past year (particularly for oil) even a modest retracing of some of the recent price declines could help offset some of Korea's export challenges.

Another interesting development that has gone largely unreported is that Korea is increasing the amount of exports it is sending to its number two trading partner, the United States. Figure 4 looks at the composition of trade among Korea's three largest trading partners. China's share of Korean exports has been flat to slightly down in recent years, but on a year-to-date basis in 2015 still commands just over a 25 percent share. Japan's portion has dropped from 7.2 percent in 2011 to just 5.0 percent so far this year.

Between 2010 and 2014, Korean exports to the United States increased more than 40 percent.

Between 2010 and 2014 (the last full year for which we have data), Korean exports to the United States increased more than 40 percent. That lifted the U.S. share of Korean exports to 12.3 percent in 2014. Year to date, the U.S. is on track to take a 13.4 percent share of Korean exports in 2015, which is a little more than half the share of exports that are destined for China for the same period. This development is likely reflective, at least in part, of a bilateral free trade agreement between the two nations that went into effect in 2012. Going forward, this agreement may play a vital role in further increases in the share of Korea's exports that are destined for the United States.

There has been a great deal of hand-wringing over negative implications for emerging markets of eventual rate increases from the Federal Reserve. The growth of Korean exports to the United States shows the other side of the coin, specifically how steady U.S. economic growth amid U.S. dollar appreciation versus the won are a positive offset.

Inflation and the Bank of Korea

Like many central banks around the world, the BoK conducts monetary policy with a mind toward achieving stable inflation, and like many central banks the drop in oil prices has been a major setback toward achieving that goal. In Korea, the inflation target is presently set to a range between 2.5 and 3.5 percent, although a new target will be set later this year.

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Some members of the BoK's MPC have advocated lowering the inflation target. Headline CPI inflation in Korea came in at just 0.9 percent on a year-over-year basis through October. Core CPI, which excludes volatile oil prices, is somewhat firmer at 2.3 percent, but still below the low end of the current target range.

Figure 5

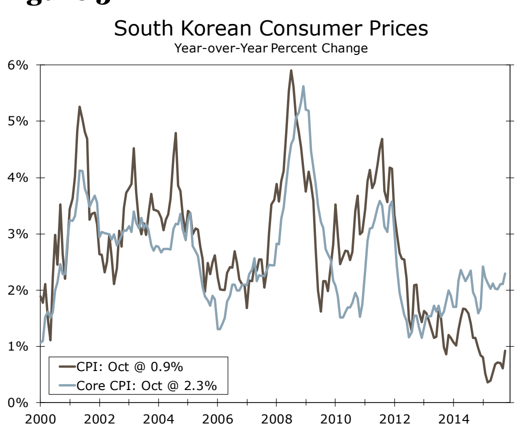
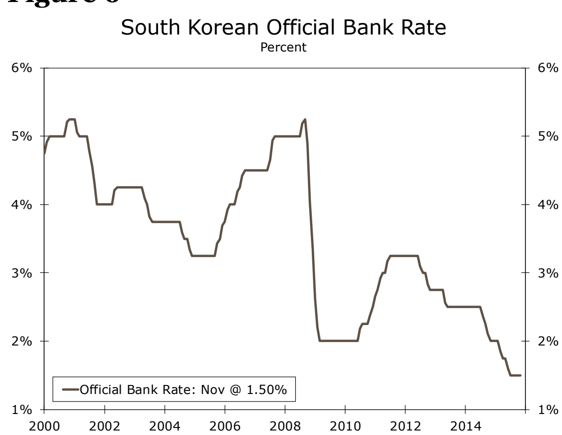


Figure 6



Source: IHS Global Insight, Bloomberg LP and Wells Fargo Securities, LLC

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The composition of the new board and the new inflation mandate present a larger-than-usual degree of uncertainty.

As we frame our thinking for the monetary policy outlook for 2016, there are a number of key points that will influence our thinking. The most conventional concern is the outlook for CPI inflation. Here, we expect to see full-year CPI inflation of just 1.6 percent. As oil's price decline fades farther into the rearview mirror, its negative influence on CPI inflation will fade. Provided inflation expectations remain anchored, we see no immediate need for further monetary policy accommodation due to prices alone. The new inflation target later this year will provide additional context.

The other big factor is that on April 13, 2016, Korea will go to the polls for a general election and the following week, terms expire for four of the seven members of the MPC. The composition of the new board and the new inflation mandate present a larger-than-usual degree of uncertainty. Barring a major move in CPI inflation or a significant disruption in domestic growth, we expect the most likely course of action is that the BoK will remain on hold.

The Domestic Demand Offset

With all the discussion around the role of net exports, Korea's domestic economy has fared rather well in 2015. As discussed previously, the MERS outbreak led to consumers staying home during much of the third quarter, resulting in a drag from consumer spending. However, that was offset during the period by modest growth in business spending as well as pickup in government expenditures.

For five straight quarters domestic demand has boosted GDP growth even as net exports exerted a drag.

Net exports have been a drag on headline GDP growth for five straight quarters and the 3.2 percentage point drag in Q3 was the largest of those periods. Interestingly, it is also true that total domestic demand has been a positive offset during each of those periods and the 7.2 percentage point boost in Q3 was also the largest of those periods. The momentum was building as the quarter went on. Retail sales finished the third quarter on a high note, posting the second fastest year-over-year increase since 2012 (Figure 7).

Figure 7

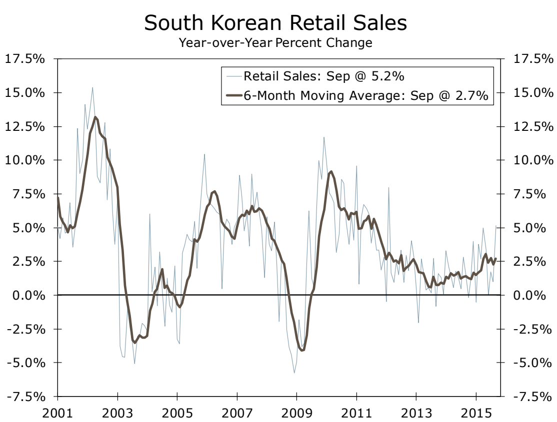
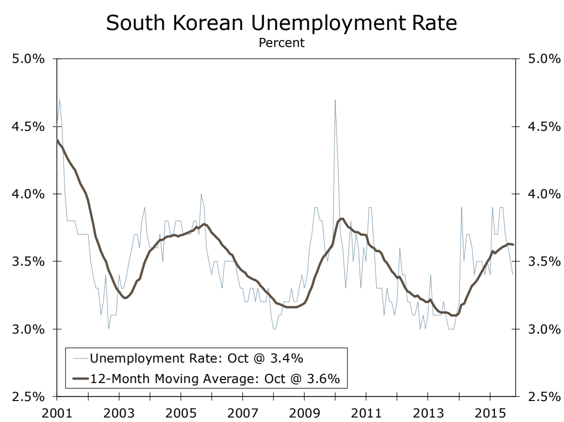


Figure 8



Source: IHS Global Insight and Wells Fargo Securities, LLC

Recent gains in the labor market may be underpinning the resilience of the Korean consumer. Although the unemployment rate has trended higher over the past couple of years, the number of jobs added in October was the largest since May. Higher rates of youth unemployment are worrying for the sustainability of consumer spending longer term, but the incremental rate of hiring should underpin consumer activity in the near term. Further out, Korea's aging demographics present the biggest risk to the sustainability of long-term domestic demand growth.

We anticipate a slower pace of government spending in 2016.

Since the start of 2013, the quarterly annualized growth rate of government spending in Korea has averaged 3.7 percent. A 22 trillion won stimulus package rolled out by the Korean government in response to the MERS outbreak helped underpin government outlays in 2015. We will get a better sense of what fiscal spending will look like when next year's fiscal budget is revealed in December. For now, we anticipate a slower pace of government spending in 2016.

Bottom Line

Korea's export-driven economy depends to a large degree on prospects for global growth. With China's economy no longer the vortex of activity it was a few years ago, much of the developing world is negatively impacted. That cuts Korea in two ways: directly, in terms of falling exports to China (Korea's top export market), and indirectly, in terms of falling exports to other economies where activity is no longer underpinned by intense Chinese demand.

Korea's export-driven economy faces headwinds from China but steady domestic demand and growing exports to the U.S. will be positive offsets.

An offset to falling exports to China is that exports to the United States are on the rise. Korean exports to the United States are now a little more than half the size of exports to China, a development which has likely been driven by a relatively recent bilateral free trade agreement between the two nations. Our forecast for continued U.S. growth and gradual firming in the dollar versus the won is supportive of further improvement in this budding trade relationship.

Domestic demand in Korea has been resilient in recent years and that has been enough to offset the export weakness. Korea also has some fairly substantial longer-term demographic problems. In the near term, however, consumer activity remains robust and incremental jobs gains are supportive of spending next year. Business spending should also be mildly supportive, although a less supportive fiscal policy environment may mean less of a boost from government spending.

CPI inflation figures will not likely face the big decline in oil prices that weighed on broader prices over the past year or so. Barring an unexpected election shake-up that could change the complexion of the MPC, we expect a gradually firming price environment combined with less of a drag from trade should keep monetary policy neutral in 2016.

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