

South Korea's Economic Outlook

- **Economic recovery is underway in South Korea as the country's COVID-19 situation remains manageable.**
- **South Korea's pandemic-related economic fallout is set to be smaller than in most other large economies, reflecting swift management of the virus outbreak combined with speedy implementation of expansionary fiscal and monetary policies.**
- **Near-term policy efforts will likely focus on fiscal stimulus as monetary policy space is rather limited.**

ECONOMIC GROWTH OUTLOOK

The South Korean economy is showing signs of recovery after dipping into a brief recession caused by the COVID-19 pandemic. South Korea has so far been able to avoid large-scale virus-triggered lockdowns and its economy is set to emerge from the crisis less damaged than many of its regional peers. High frequency indicators—such as consumer and business confidence and exports—have started to improve over the past few months. Nevertheless, still-weak labour market conditions and soft global demand imply that economic activity will take a while to reach pre-crisis levels.

The South Korean economy has recorded two consecutive quarterly contractions in real GDP, meeting the technical definition of a recession. According to preliminary data, real GDP declined by 3.3% q/q (non-annualized) in the second quarter, following a 1.3% drop in the January–March period (chart 1). In year-over-year terms, output contracted by 2.9% in Q2 after a 1.4% gain in the first quarter. We expect the economy to rebound in the second half of 2020 and into 2021. We assess that South Korea's real GDP growth for 2020 as a whole will remain in negative territory of around 1½%. In 2021, the economy will likely bounce back by 3.1%, underpinned by stimulative policies, pent-up demand and a revival in international trade as the global economy gets back on its feet.

The biggest uncertainty surrounding South Korea's recovery dynamics relates to the country's external sector. As the economy is highly export-oriented—exports of goods and services account for 40% of GDP, one of the highest ratios in Asia-Pacific—still-subdued demand conditions around the world will likely be a drag on the South Korean economic rebound. Moreover, potential new large waves of COVID-19 infections add to the uncertainties. South Korea's exports bottomed out in April and have been on a recovery path since, yet they still remain below year-earlier levels (chart 2).

Domestic demand will be a crucial factor for lifting the economy out of recession. Household spending will likely strengthen over the coming months as consumer confidence continues to recuperate gradually along with a stabilizing labour market (chart 3). Nevertheless, new virus outbreaks can quickly reverse recent improvements in sentiment. Similarly, we expect fixed investment to recover in the second half of the year, responding to loose monetary conditions and the government's investment incentives, such as tax deductions.

CONTACTS

Tuuli McCully, Head of Asia-Pacific Economics
65.6305.8313
Scotiabank Economics
tuuli.mccully@scotiabank.com

Chart 1

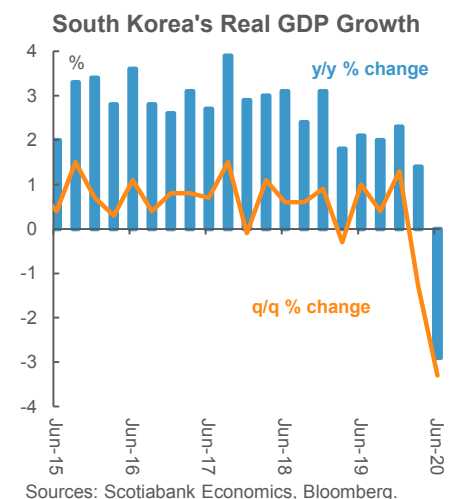
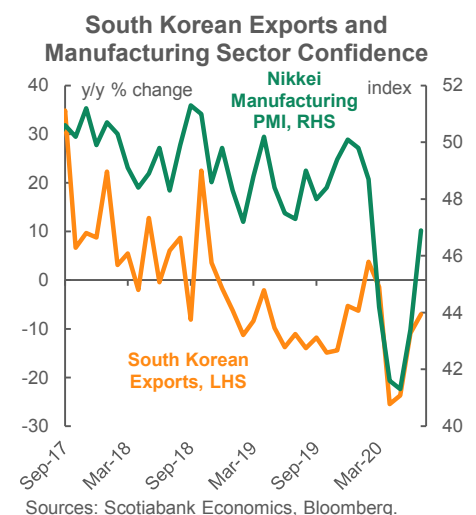


Chart 2



Public outlays will provide notable support to South Korea's economic activity. Fiscal policy has become increasingly expansionary; the government has promptly unveiled three supplementary budgets this year to offset some of the adverse impacts of the pandemic. According to the Ministry of Economy and Finance, the government's COVID-19-related policy measures total KRW277 trillion, equivalent to 14.4% of GDP. Announced measures include cash handouts to households, labour market support, incentives for private sector facilities investment, public construction projects, as well as financial aid, loans and loan guarantees for businesses. As the latest policy announcement, the government unveiled the "Korean New Deal" in mid-July, which is an economic transformation plan worth KRW160 trillion—to be spent through 2025—that will seek to create jobs and underpin the economy. The package focuses on boosting longer-term growth drivers related to the digital and green economy as well as on building a stronger social safety net.

We assess that policy efforts through the rest of the year will focus on the implementation of announced fiscal stimulus measures, rather than on additional monetary easing. In our view, the country has fiscal space left should the economy need an additional boost. South Korea entered the COVID-19 crisis in a stronger fiscal position than many of its peers. According to the International Monetary Fund, the nation's general government balance recorded a surplus of 0.9% of GDP in 2019. Its public debt level—of 40% of GDP in 2019—is relatively low in global comparison. Despite higher debt and deficits this year and beyond, South Korea's public finances remain sustainable.

MONETARY POLICY, INFLATION AND WON OUTLOOK

Accommodative monetary policy will complement the government's fiscal stimulus efforts. The Bank of Korea (BoK) has cut the benchmark interest rate by a total of 75 basis points this year. The latest cut took place following the monetary policy meeting on May 28, when the BoK lowered the Base Rate by 25 bps to 0.50% (chart 4). Since then, the BoK has left monetary policy on hold. We do not expect any further rate cuts over the foreseeable future; indeed, BoK Governor Lee Ju-yeol has pointed out that the benchmark interest rate is now close to the effective lower bound. Nevertheless, should the economic recovery come to a halt, the BoK could opt to use unconventional policy tools, such as quantitative easing to keep long-term interest rates low. Since March, the central bank has been buying government bonds through open market operations to improve liquidity in the financial system.

South Korean inflationary pressures are virtually non-existent. The consumer price index rose 0.3% y/y in July, far away from the BoK's inflation target of 2% y/y. Soft demand-driven price pressures will likely persist in the near term with headline inflation expected to close the year at 0.1% y/y. Base effects and the anticipated economic revival will likely lift the inflation rate higher next year, yet we expect it to remain below the 2% mark through 2021, giving a further incentive to the BoK for keeping an accommodative monetary policy stance in place for the foreseeable future.

The Korean won (KRW) will continue to be influenced by changes in global risk appetite, equity portfolio flows, and trade-related developments (chart 5). The won remains highly susceptible to the US-China conflict. We assess that there is a risk of an escalation in the US-China tensions ahead of the US presidential election in November. Accordingly, we expect the KRW to depreciate somewhat against the US dollar (USD) before year-end, with USDKRW likely to close the year at 1,220.

Chart 3

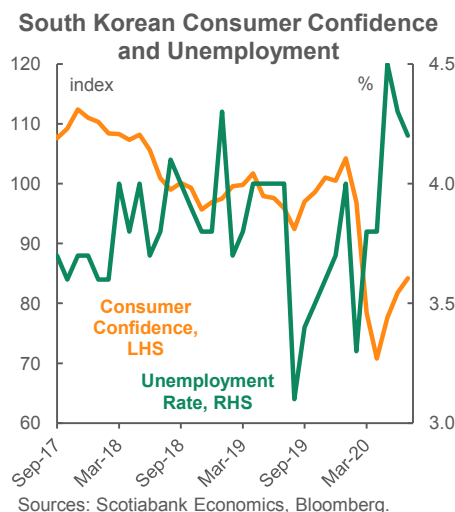


Chart 4

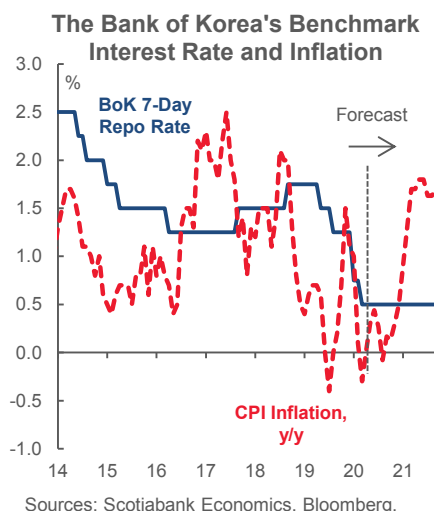
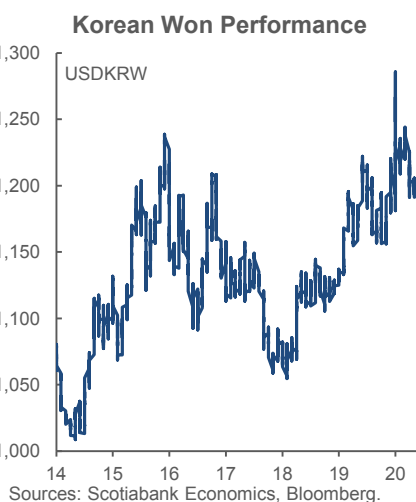


Chart 5



This report has been prepared by Scotiabank Economics as a resource for the clients of Scotiabank. Opinions, estimates and projections contained herein are our own as of the date hereof and are subject to change without notice. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made as to their accuracy or completeness. Neither Scotiabank nor any of its officers, directors, partners, employees or affiliates accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or its contents.

These reports are provided to you for informational purposes only. This report is not, and is not constructed as, an offer to sell or solicitation of any offer to buy any financial instrument, nor shall this report be construed as an opinion as to whether you should enter into any swap or trading strategy involving a swap or any other transaction. The information contained in this report is not intended to be, and does not constitute, a recommendation of a swap or trading strategy involving a swap within the meaning of U.S. Commodity Futures Trading Commission Regulation 23.434 and Appendix A thereto. This material is not intended to be individually tailored to your needs or characteristics and should not be viewed as a "call to action" or suggestion that you enter into a swap or trading strategy involving a swap or any other transaction. Scotiabank may engage in transactions in a manner inconsistent with the views discussed this report and may have positions, or be in the process of acquiring or disposing of positions, referred to in this report.

Scotiabank, its affiliates and any of their respective officers, directors and employees may from time to time take positions in currencies, act as managers, co-managers or underwriters of a public offering or act as principals or agents, deal in, own or act as market makers or advisors, brokers or commercial and/or investment bankers in relation to securities or related derivatives. As a result of these actions, Scotiabank may receive remuneration. All Scotiabank products and services are subject to the terms of applicable agreements and local regulations. Officers, directors and employees of Scotiabank and its affiliates may serve as directors of corporations.

Any securities discussed in this report may not be suitable for all investors. Scotiabank recommends that investors independently evaluate any issuer and security discussed in this report, and consult with any advisors they deem necessary prior to making any investment.

This report and all information, opinions and conclusions contained in it are protected by copyright. This information may not be reproduced without the prior express written consent of Scotiabank.

™ Trademark of The Bank of Nova Scotia. Used under license, where applicable.

Scotiabank, together with "Global Banking and Markets", is a marketing name for the global corporate and investment banking and capital markets businesses of The Bank of Nova Scotia and certain of its affiliates in the countries where they operate, including, Scotiabanc Inc.; Citadel Hill Advisors L.L.C.; The Bank of Nova Scotia Trust Company of New York; Scotiabank Europe plc; Scotiabank (Ireland) Limited; Scotiabank Inverlat S.A., Institución de Banca Múltiple, Scotia Inverlat Casa de Bolsa S.A. de C.V., Scotia Inverlat Derivados S.A. de C.V. – all members of the Scotiabank group and authorized users of the Scotiabank mark. The Bank of Nova Scotia is incorporated in Canada with limited liability and is authorised and regulated by the Office of the Superintendent of Financial Institutions Canada. The Bank of Nova Scotia is authorised by the UK Prudential Regulation Authority and is subject to regulation by the UK Financial Conduct Authority and limited regulation by the UK Prudential Regulation Authority. Details about the extent of The Bank of Nova Scotia's regulation by the UK Prudential Regulation Authority are available from us on request. Scotiabank Europe plc is authorised by the UK Prudential Regulation Authority and regulated by the UK Financial Conduct Authority and the UK Prudential Regulation Authority.

Scotiabank Inverlat, S.A., Scotia Inverlat Casa de Bolsa, S.A. de C.V., and Scotia Derivados, S.A. de C.V., are each authorized and regulated by the Mexican financial authorities.

Not all products and services are offered in all jurisdictions. Services described are available in jurisdictions where permitted by law.