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Economics Group

WELLS FARGO SECURITIES

Special Commentary

Michael Pugliese, Economist
michael.d.pugliese@wellsfargo.com • (212) 214-5058
Hop Mathews, Economic Analyst
hop.mathews@wellsfargo.com • (212) 214-5058

The South Korean Economy: An Update

Executive Summary

On March 5, we published a report examining the South Korean economy in the context of its COVID-19 outbreak. With the advantage of hindsight, we now know that the report roughly coincided with the peak of the outbreak in South Korea: new cases topped out at 851 on March 3 and steadily declined thereafter. Over the past few months, the South Korean economy has held up reasonably well, at least on a relative basis. Real GDP contracted at a 5.5% annualized rate in Q1 in South Korea, but the country's economy should not see a Q2 contraction nearly as big as is anticipated in many other developed market economies, such as the United States or the Eurozone. Korea's signs of improving data and supportive economic policy backdrop all offer reasons to be at least relatively constructive of the Korean outlook. We believe that could also translate in to the outlook for the Korean won, which we believe will likely weaken only modestly in the short-term, but recover more significantly over time.

That said, the budding recovery has been uneven across different parts of the economy. Tourism from international arrivals was still essentially nonexistent in April, and an index of air travel activity was at its lowest point on record in April. At 14.5, the index was still down nearly 90% from its January level. And although the hotel & food industry has started to see a rebound, activity in the industry remains significantly depressed.

Figure 1

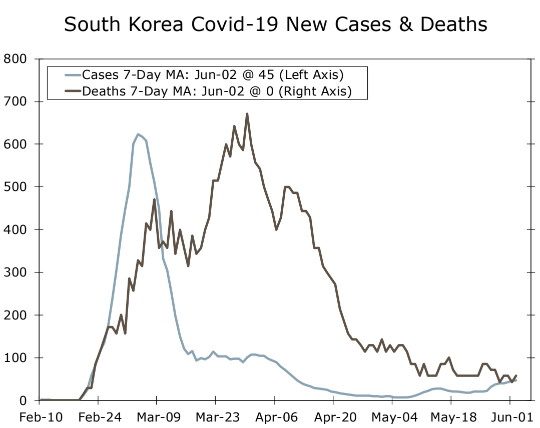
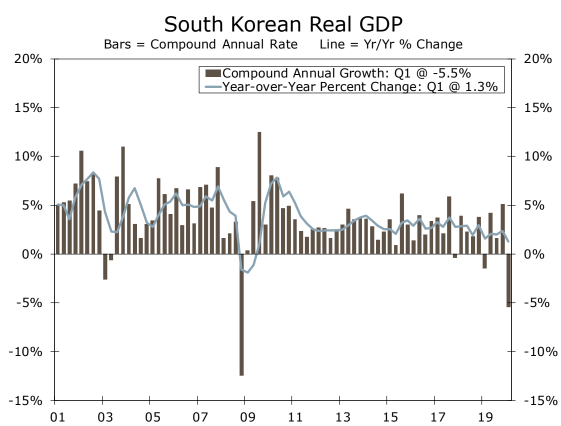


Figure 2



Source: Bloomberg LP, IHS Markit and Wells Fargo Securities

South Korean Economy Showing Relative Resilience

The less severe outbreak in South Korea has largely allowed the country to avoid the most severe lockdowns.

South Korea was one of the first countries to experience a serious COVID-19 outbreak outside of China. New cases began to accelerate in February and peaked at 851 confirmed new cases on March 3. In the subsequent weeks, case growth slowed significantly, in contrast with the experience in many Western countries (Figure 1). By late March, transmission of COVID-19 was largely in check, with daily fatalities down into the low single digits. The less severe outbreak in South Korea has largely allowed the country to avoid the most severe lockdowns put in place in other parts of the world. Bars and restaurants, for example, have largely been permitted to stay open, with some exceptions at different points in time and in various locations.

The South Korean economy has held up reasonably well, at least on a relative basis.

Against that backdrop, the South Korean economy has held up reasonably well, at least on a relative basis. Real GDP contracted at a 5.5% annualized rate in Q1 in South Korea (Figure 2), a bit more than the 5.0% rate registered in the United States, but much better than the 19.6% annualized decline in Italian real GDP. With one month left in Q2, the South Korean economy appears likely to significantly outperform the United States and European economies in the second quarter. Real retail sales in South Korea rose 9.6% in March and 2.1% in April. Those gains helped offset sizable declines in January and February, so much so that on a year-over-year basis real retail sales were down just 2.2% in April (Figure 3). Similarly, industrial production in South Korea was down 1.7% year-over-over in April, compared to 15.0% in the United States (Figure 4).

Figure 3

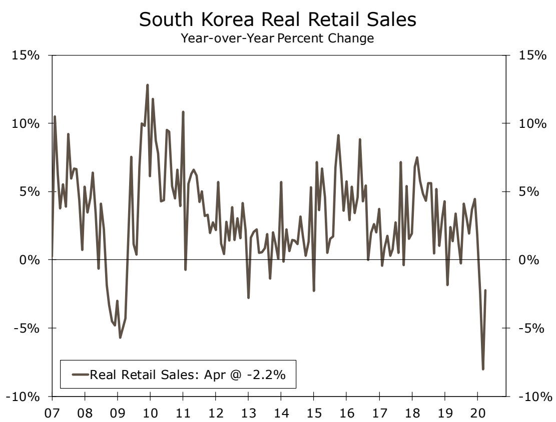
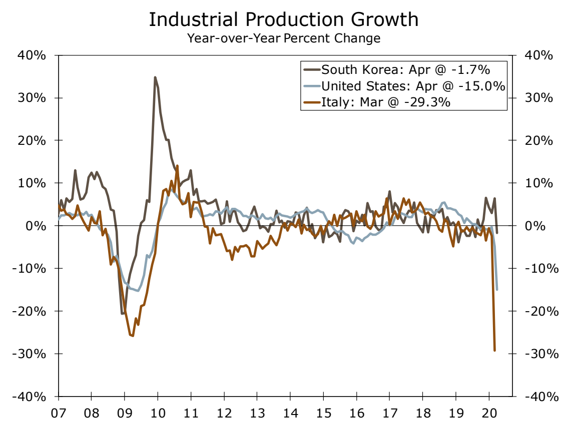


Figure 4



Source: Bloomberg LP, IHS Markit and Wells Fargo Securities

The more promising economic outlook in South Korea is reflected in forecasts for the country's full-year real GDP growth. In its most recent economic outlook, the country's central bank forecast that real GDP would decline just 0.2% in 2020. The International Monetary Fund's forecast is more bearish at -1.2% real GDP growth, but even this modest decline would be a significant outperformance compared to our expected contractions in the United States and the Eurozone of 4.6% and 8.0%, respectively. In a report earlier this year, we noted the risks to the South Korean economy given its high level of exposure to the Chinese economy, where COVID-19 originated. But the Chinese economy has outperformed in recent months, this exposure may turn out to be more of an asset than a liability. South Korean exports declined 21.1% month-over-month in March, and that enormous contraction was followed by another 4.6% decline in April. But, exports to China fell just 5.0% in April and then rose by 5% in May.

Tourism from international arrivals was still essentially nonexistent in April.

That said, the budding recovery has been uneven across different parts of the economy. Tourism from international arrivals was still essentially nonexistent in April (Figure 5), and an index of air travel activity was at its lowest point on record in April. At 14.5, the index was still down nearly 90% from its January level. And although the hotel and food industry has started to see a rebound, activity in the industry remains significantly depressed (Figure 6). The ongoing challenges in industries like travel and food service in South Korea offer some evidence that solving these industries' woes in other economies will not be as simple as just allowing the businesses to reopen, even if this is an important first step.

Figure 5

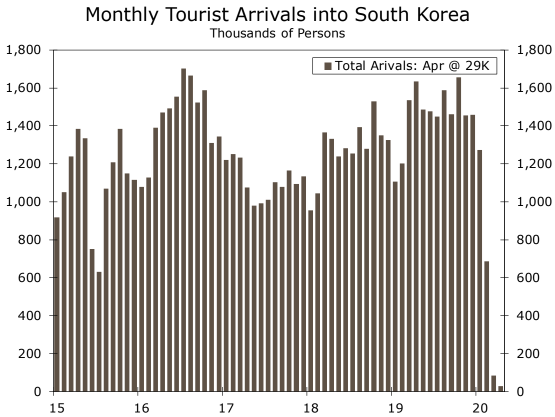
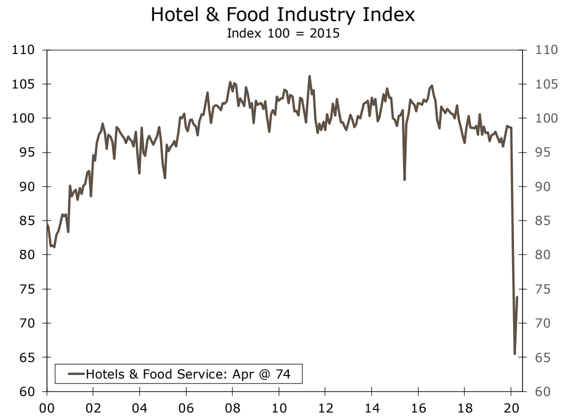


Figure 6



Source: Bloomberg LP, IHS Markit and Wells Fargo Securities

Korean Policymakers Helping as Best They Can

In addition to the relatively successful push to keep COVID-19 in check, the response of policymakers is aiding the resilience of the Korean economy. The Bank of Korea cut rates 25 bps in late May, bringing its main policy rate to 0.50%, down from 1.25% to start the year. The central bank highlighted that rates are nearing their lower bound, but indicated that it is open to further use of non-interest policy tools, even if it was not specific as to what those might be. Interest rates are already fairly low in South Korea, with the 10-year sovereign bond yielding 1.35% as of this writing, but perhaps they could be pushed another 50-75 bps lower through a bond buying program.

The Korean government is stepping up with a reasonably robust fiscal response.

On the fiscal side, the Korean government is stepping up with a reasonably robust fiscal response. To date, two supplementary budget proposals have been adopted totaling 23.9 trillion won. In addition, Korean policymakers recently announced that the government plans to submit to parliament a third plan for fiscal expansion worth 35.3 trillion won. If enacted, this would bring the cumulative total for the extra budgets to around 59 trillion won, or 3.1% of GDP. While not that sizeable compared to many developed Western economies, for the typically fiscal cautious Korean government that is a noteworthy response. Furthermore, the gross debt-to-GDP ratio of the general government was just 40.7% in 2019, so there is plenty of additional fiscal space if needed. Indeed, the government's contribution to the economy appears to offsetting some of the private sector weakness, helping Korea to navigate through the COVID-19 crisis while avoiding excessive economic fallout (Figures 7 and 8).

Figure 7

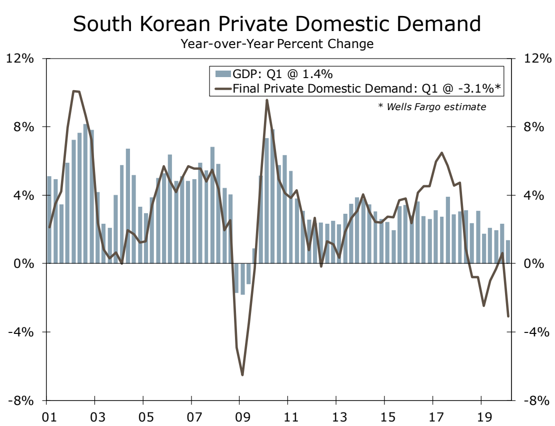
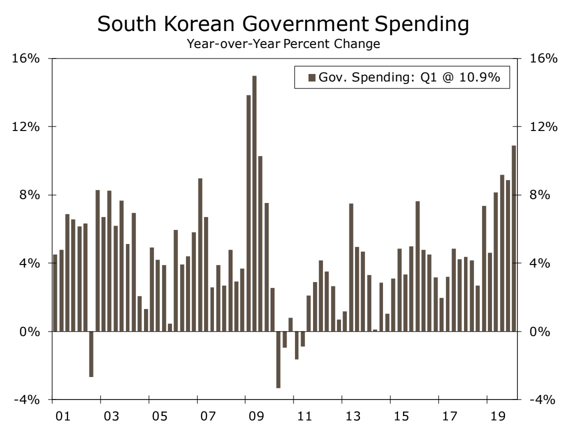


Figure 8



Source: IHS Markit and Wells Fargo Securities

Korea's trade linkages to China, signs of improving data and supportive economic policy backdrop all offer reasons to be at least relatively constructive of the Korean outlook. We believe that could also translate in to the outlook for the Korean won, which we believe will likely weaken only modestly in the short-term, but recover more significantly over time.

Wells Fargo Securities Economics Group

Jay H. Bryson, Ph.D.	Acting Chief Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	International Economist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Azhar Iqbal	Econometrician	(212) 214-2029	azhar.iqbal@wellsfargo.com
Sarah House	Senior Economist	(704) 410-3282	sarah.house@wellsfargo.com
Charlie Dougherty	Economist	(704) 410-6542	charles.dougherty@wellsfargo.com
Michael Pugliese	Economist	(212) 214-5058	michael.d.pugliese@wellsfargo.com
Brendan McKenna	International Economist	(212) 214-5637	brendan.mckenna@wellsfargo.com
Shannon Seery	Economic Analyst	(704) 410-1681	shannon.seery@wellsfargo.com
Matthew Honnold	Economic Analyst	(704) 410-3059	matthew.honnold@wellsfargo.com
Jen Licis	Economic Analyst	(704) 410-1309	jennifer.licis@wellsfargo.com
Hop Mathews	Economic Analyst	(704) 383-5312	hop.mathews@wellsfargo.com
Coren Burton	Administrative Assistant	(704) 410-6010	coren.burton@wellsfargo.com

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