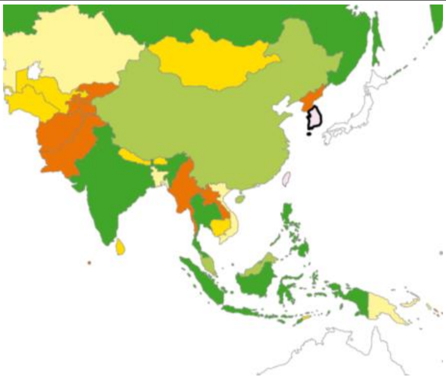
COUNTRY RISK ANALYSIS

South Korea

CREATING CONFIDENCE IN YOUR EXPORTS

ekn



COUNTRY RISK CATEGORY

1/7

The country risk categories range from 0 to 7. The lower the number the better the credit rating the country has.

0 1 2 3 4 5 6 7

EKN'S OUTSTANDING GUARANTEES TO THE COUNTRY

SHORT-TERM TRANSACTIONS:
SEK 12 MILLION

MEDIUM AND LONG-TERM TRANSACTIONS:
SEK 668 MILLION

DATE

24 OCTOBER 2014

Reforms initiated in strong economy

South Korea has a strong macro-economic position. A well-functioning institutional framework for macro-economic policies contributes to relatively stable growth and low inflation. However, the economy is facing structural challenges. The country is having trouble getting back to the levels of growth it achieved before the global financial crisis. This is due to the fact that the economy has become increasingly split between the successful export sector and the domestic economy, which is characterised by high debt and low income growth. An ambitious reform programme was launched in 2014. A transformation of the economy will be promoted in order to strengthen domestic consumption, the service sector and innovation, while reducing its dependence on exports in the long term. This will enable the country to meet the structural challenges and strengthen the country's waning growth potential in the long term. As a result of this, and the "North Korean factor", South Korea will retain the same country risk category. Overall, the country's solid macro-economic position ensures its ability to manage both long-term challenges and temporary declines.

THE COUNTRY'S STRENGTHS AND WEAKNESSES

Strengths

- Well-developed industry and competitive export sector
- Strong external sector with repeated account balance surpluses, low external debt and substantial international reserves
- Limited public debt and well-functioning macro-political institutions

Weaknesses

- High export dependence and large financing needs in the banking sector expose the economy to external disruptions
- High and increasing private sector debt, especially household debt
- Latent security threat from North Korea

EKN'S POLICY

Risk assessment

EKN has placed South Korea in country risk category 1 since 2006. As is the case with the other high-income countries in the OECD, South Korea is not categorised within the scope of the OECD's country risk categorisation. Therefore, there are also special rules for the OECD's minimum premiums, which are to be based on market benchmarks for these countries. Neither the business environment nor the economic conditions in the country necessitate special restrictions on EKN's policy. Each transaction is assessed on its own merits.

WHAT MIGHT CAUSE A CHANGE IN THE COUNTRY POLICY?

The policy may be made less restrictive in the event of

- Reforms that strengthen growth potential while retaining competitiveness
- Successful management of the debts of state-owned enterprises and private sector debt being sustainable in the long term
- External debt continuing to fall and strong international reserves

The policy may be made more restrictive in the event of

- Growing economic imbalances and an unsustainable increase in the economy's debt which could jeopardise financial stability and/or the public finances.
- A very negative development in the security situation on the Korean Peninsula

EKN'S EXPOSURE AND EXPERIENCE

Increased provision of guarantees

The provision of guarantees over the past ten years totals SEK 1.2 billion. The shipbuilding industry and the logistics sector account for close to 25 per cent. More than half of the guarantees are for new telecom transactions, which resulted in an increase in the provision of guarantees in recent years. EKN's exposure totals SEK 2.6 billion, with guarantees amounting to SEK 670 million. The rest is made up of offers. EKN has overall positive experience. A number of delays occurred in connection with the global financial crisis. The delays were mainly attributable to a handful of Korean SMEs in logistics and the shipbuilding industry. SEK 10 million in indemnifications have been paid since 2008.

COUNTRY ANALYST

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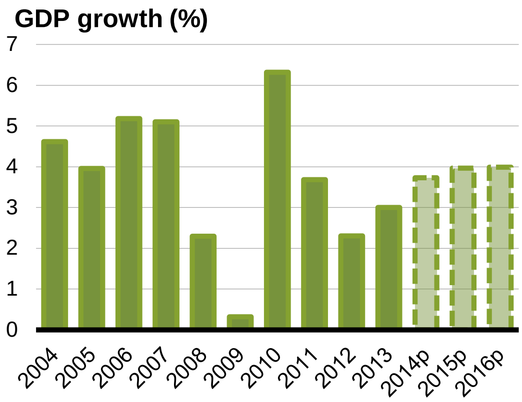
DISCLAIMER

Strong economy can overcome challenges

South Korea has good political stability with a democratic system that is now well-established. Nevertheless, there is a latent security threat hovering over the Korean Peninsula. The change in leadership in North Korea has not brought about a more conciliatory attitude toward the rest of the world. South Korea's economy has however proven to be relatively insusceptible to North Korea's recurring provocations over a long period of time. The risk of armed conflict or the collapse of the regime in North Korea is estimated to be low in the coming years.



Source: IMF

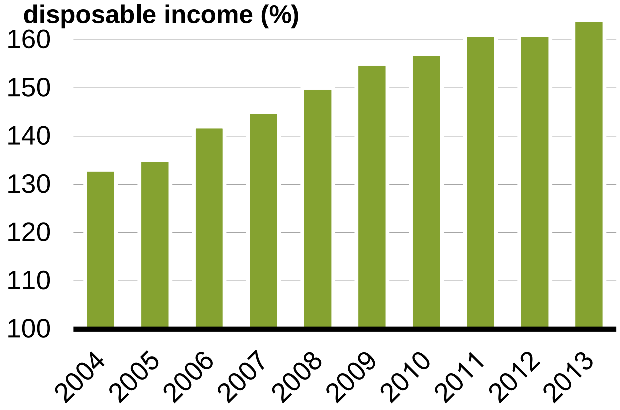
South Korea has a strong macro-economic position. The country is currently the world's 15th largest economy, with a GDP per capita equal to 60 per cent of the OECD average. The country is a leading export nation with strong position in electronics, telecoms, the automotive industry and the shipbuilding industry. The government also has an investment grade credit rating. A well-functioning institutional framework for macro-economic policies ensures continuing relatively stable growth and low inflation. Since exports account for 55 per cent of GDP and China is its largest trade partner, the country's growth prospects rely on a certain degree of recovery in the OECD and on China avoiding a sharp slowdown. In the baseline scenario, growth is strengthened after a couple of weak years and will reach over 3.5 per cent per year in the coming years.

South Korea has a strong macroeconomic position. The national budget has run a surplus in 13 of the last 14 years. The national debt is slightly above 35 per cent of GDP. If state-owned enterprises are included, this increases to a moderate 65 per cent. Factors of strength include that the majority of the debt is in domestic currency and that the government has financial savings amounting to over 35 per cent of GDP, mainly in the national pension fund. The banking system is considered sound. The high level of private sector debt is a cause for concern in the event of a deeper economic decline, but the stress tests conducted by the IMF indicate solid capitalisation. The previous high exposure of the banks to short-term foreign financing has been reduced considerably since 2008, which has reduced the vulnerability of the banking system.

The country's external sector is very strong. The current account balance has run a steady surplus since 1998. The fact that the currency of South Korea's competitor Japan has weakened is having a negative effect on the country's export prospects. However, exports are expected to benefit from the ongoing recovery in the US, the country's free trade agreement with the US and the EU and growing trade in Asia, especially with China. The country's external debt is moderate at 30 per cent of GDP, and its total assets (public international reserves, foreign exchange assets held by banks and companies) exceed its external debt. The country's international reserves are equal to two times its external debt due within one year. In addition, South Korea has buffers in the form of bilateral swap agreements with Japan and China.

South Korea is facing a series of structural challenges. The successes of the economy's cornerstone, the export-oriented business conglomerates (*Chaebols*), are trickling down less and less to the domestic economy. Chaebols have accumulated sizeable profits and currently hold large liquid assets, without household income keeping pace or investments in South Korea increasing. Corporate investments are increasingly being directed abroad instead. In the SME sector, which employs over 80 per cent of the workforce, productivity and wages are low.

The ratio of household debt to disposable income (%)



Source: HSBC and OECD. OECD average 133% 2012

Household debt has also increased and is now among the highest in the OECD at nearly 165 per cent of disposable income. Domestic consumption is thus falling. As a result, the economy's export dependency and its sensitivity to economic downswings has increased. The rapidly ageing population is another challenge in the coming decades. In the long term, this is expected to slow down the country's growth potential and increase the pressure on the public finances.

President Park Geun-hye (2013-2017) launched an ambitious reform programme in the spring of 2014. The aim of the programme is to promote a transformation of the economy to be able to manage the structural challenges and strengthen the country's waning growth potential. A transformation of the economy's focal point is being sought, from the export-oriented manufacturing industry to domestic demand and a growing and more productive services sector. These structural reforms are now being combined with slightly more expansionary fiscal and monetary policies. The president's conservative Saenuri Party secured a stronger majority in the National Assembly in the spring of 2014, this will last until the parliamentary elections in 2016. This is expected to speed up the rate of reform. The country's strong macro-economic foundation also strengthens its ability to manage both temporary downswings and long-term challenges.

BUSINESS ENVIRONMENT

The largest industrial sectors (automotive, telecom, electronics, the steel industry, the shipbuilding industry and the petrochemicals industry) are dominated by the family-controlled Chaebols. State-owned enterprises control sectors such as telecom, power and transport. While the largest companies perform well in terms of profitability, IMF studies indicate weaknesses in the form of high debt and low profitability in some sectors, such as the shipbuilding sector, the construction sector and the transport sector. The SME sector enjoys extensive state support measures in the form of loans and guarantees, but tends to suffer from weak profitability. Up to a third of SMEs tend to not earn enough to cover ongoing interest payments (OECD 2014).

The country's business environment, which has been strengthened significantly since the 1998 Asia crisis, is considered good. The country's institutions and state apparatus function well, even though not all aspects of the country reach the absolute top level in global indices that measure the corporate and regulatory climate. It is thought that the powerful Chaebols exert influence on regulatory and competition issues at times. The often complicated company and ownership structures of the conglomerates have historically raised questions concerning transparency and governance, but this is gradually subsiding as financial reporting improves and foreign shareholdings grow. On the legal side, insolvency and collateral legislation has been reformed gradually and is now considered well-functioning, and foreign creditors are statutorily equal to Korean ones in the event of insolvency.

The financial transparency of companies has been strengthened. An extensive transition to International Financial Reporting Standards (IFRS) was made from 2007 to 2011. IFRS is now used for listed companies, financial institutions and state-owned enterprises. IFRS is voluntary for unlisted companies. SMEs, which the great majority of Korean companies are, follow the *Korean Accounting Standards for Non-Public Entities*, which is considered to result in weaker transparency.