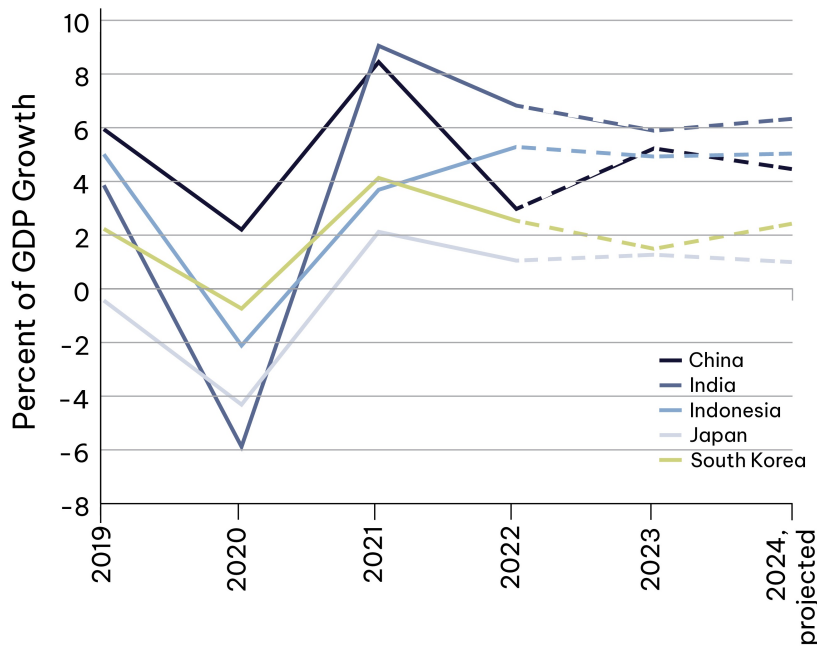




South Korean Economy Facing Headwinds

GDP Growth Rates of the Largest Indo-Pacific Economies



Source: IMF

The South Korean economy is noticeably sputtering, especially in comparison to stronger post-COVID recoveries elsewhere in Asia.

Korea's exports are down 15 percent year-on-year. Meanwhile, interest rate hikes by the Bank of Korea (BOK) to stem inflation have been largely successful but have hit the country's USD 107 billion housing market and construction industry especially hard. Housing prices fell in April for the eleventh straight month and are down about ten percent from their peak last summer. Residential real estate is the largest class of assets for most Korean households, so a drop in values can have a strong and negative wealth effect on household spending.

Overall, in Q1 2023, the country posted only 0.3 percent growth from the previous quarter – and that was due largely to unusually high automotive exports. In Q4 2022, the economy contracted by 0.4 percent from the previous quarter. Most economists now expect South Korea to only narrowly **avoid** a recession for this full calendar year.

Perhaps most worrying is that the depth of South Korea's housing problem puts the country at the top of the list in East Asia in terms of its near-term financial risk profile. S&P Global believes that the country's high level of household debt creates unique macroeconomic vulnerability. Capital Economics has similarly argued that the country's large household debt-to-GDP ratio could put a serious drag on the economy.

This uncertain outlook carries risks both for businesses operating in South Korea and the country's foreign policy.

Domestic Doldrums

Housing prices and exports are two critical issues to watch going forward.

Korean consumers will likely continue to spend less on non-essential items if housing prices continue to fall, undermining any rebound in the services sector. Recent activity in that sector has come largely from robust financial services growth, which will likely ease as well due to the lagged impact of monetary tightening. The BOK's April forecast that consumer demand for services will boost growth seems too optimistic.

Meanwhile, South Korea's all-important exports are heavily concentrated in a few industries.

China, Hong Kong, Taiwan, and Vietnam are the **top** purchasers of South Korea's integrated circuits (its top export). China and Hong Kong are projected to grow only moderately this year; growth is expected to slow in **Taiwan** and **Vietnam**.

The United States, Canada, Russia, the United Kingdom, and Australia are the top purchasers of South Korean cars (its second-largest export). Russia is **expected** to post only 0.7 percent growth this year, with the economic fallout from the war and sanctions reducing consumers' purchasing power. The other four countries are **expected** to see growth slow in 2023.

Given this outlook, export revenue is unlikely to significantly offset South Korea's domestic economic woes. **The upshot is that TAG clients will probably see sharply lower South Korean household consumption of luxury items and services like tourism.**

Deeper Implications

The fragility of South Korea's economy also weighs on President Yoon

Suk Yeol's political standing. His approval rating is low, at **around** 36 percent. The 58 percent who give Yoon negative marks highlight the economy and labor conditions as top factors.

Workers in several major South Korean industries went on strike for nearly three weeks late last year. That strike ended only after the government expanded back-to-work orders for up to 10,000 people. Seoul offered no concessions. Opposition officials have therefore criticized Yoon for prioritizing the interests of large firms over workers, noting that his government has not mandated higher wages. Broader public views of the strike appear to be more mixed.

Economic weakness is also no doubt impinging on Yoon's foreign policy. For example, Seoul's rejection of some aspects of Washington's entreaties to limit high-tech exports to China reflects South Korea's dependence on that channel for exports and growth. Continued poor economic performance might also prompt Yoon to deprioritize foreign policy - including his efforts to boost ties across the Indo-Pacific - in favor of domestic issues. Yoon's personal commitment to improving ties with Japan, however, still seems unquestioned at this point, despite some domestic political pushback.

Looking to the long-term, issues like South Korea's demographics (its fertility rate is among the world's lowest), the nation's large amount of **household** debt, declining labor productivity, and complex regulatory environment all risk further dampening the country's sustained economic growth.

*This report was prepared by **Charles Dunst**.
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