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Korea's first line of defense: Fiscal and ultimately more monetary stimulus

Taking advantage of bad news

In the aftermath of Brexit, uncertainty is dampening global demand outlook. While slower UK growth will have a marginal impact on emerging (EM) Asia, the region will suffer significantly should EU's demand for Asian goods deteriorate as a result. This is not our base case scenario: Our UK and Eurozone economists expect UK GDP to slow to 0.5% in 2017 from 1.6% in 2016. For the EU, the impact is not as profound, with GDP slowing to 1.4% from 1.6% in 2016 and decelerating to 1.2% in 2017. As one of the trade exposed countries in the region, Korea is the first country in Asia to move quickly to limit the downside to its already fragile economic performance (more countries will likely follow).

The government downgraded its 2016 GDP forecast to 2.8% from 3.1% previously and lowered CPI forecast to 1.1% from 1.5% previously. President Park stated that "external conditions surrounding Korea get serious" and called for "all necessary steps to stabilize markets." Fiscal policy is being deployed – the government is submitting a KRW20trn (USD17bn) fiscal stimulus to parliament shortly. Note that only KRW10trn (0.6% of GDP and 2.6% of expenditure) is actually new stimulus as the previous KRW10trn was already announced as part of the recapitalization plan. We believe that the KRW20trn is helpful, but it is not enough given its tiny size. **And given that the government is conservative with fiscal policy, this ultimately means that the Bank of Korea (BOK) will deliver another 25bps rate cut this year to support the economy, taking rate to 1%**.

Table 1. A summary of latest forecasts

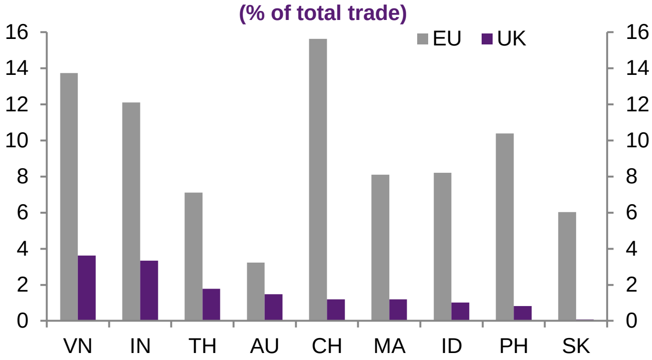
	Old Government Forecast	New Government Forecast	Natixis	Consensus
GDP	3.1%	2.8%	2.5%	2.6%
CPI	1.5%	1.1%	1.5%	1.2%

Source: Bloomberg, Natixis

Is the impact as bad as President Park stated?

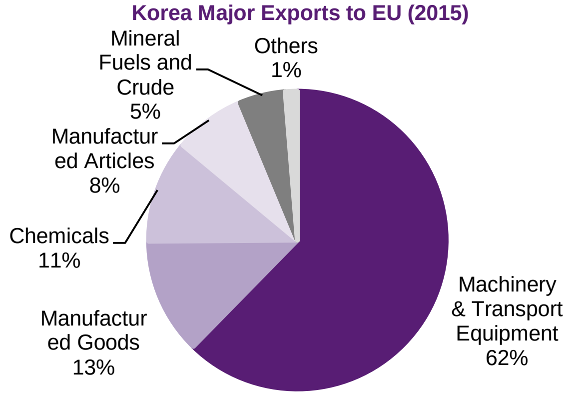
President Park used very strong and serious words regarding the external pressures on Korea's outlook. The question is whether the economy is really that impacted by Brexit or it is an opportunistic tool to get the fiscal stimulus to pass the parliament, especially as the Saenuri no longer has the majority. To do this, we look at Korea's trade and financial linkages with the UK and the EU.

Chart 1
Korea's exports to the UK is the lowest in Asia and direct shipments to EU is 6%
(% of total trade)



Source: Bloomberg, Natixis

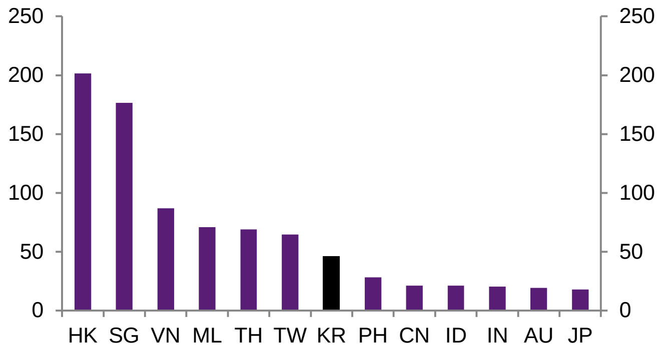
Chart 2
Korea Major Exports to EU (2015)



Source: Bloomberg, Natixis NB total = 46 USDbn

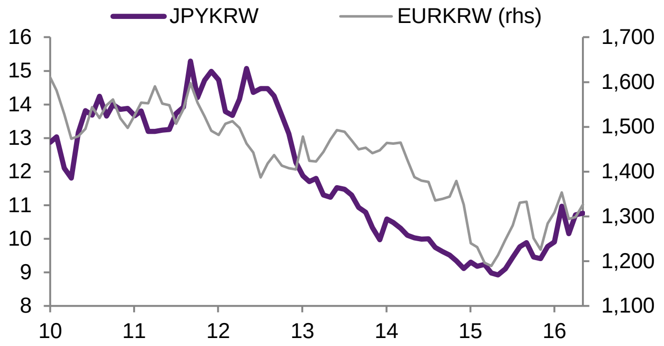
Chart 1 shows the direct impact of weaker UK and EU demand on Korea. Clearly, Korea has the least exposure to the UK from an export perspective, especially with a weaker sterling dampening demand further. And directly, this would not impact Korea as much as China. Thus, at least in the short-term, Brexit impact on trade for Korea will likely be very small. However, given that Korea's largest export market is China (25% of total exports) and exports make up 46% of GDP, a pro-longed EU slowdown will come back to bite Korea through lower China demand and through global demand and supply linkages. **Chart 2** shows the decomposition of Korean exports to the EU in 2015. Machinery and transport equipment made up most of the shipments. Should growth deteriorate significantly in the EU, Korea's major industries will be affected.

Chart 3
Exports as a share of GDP (%, 2015)



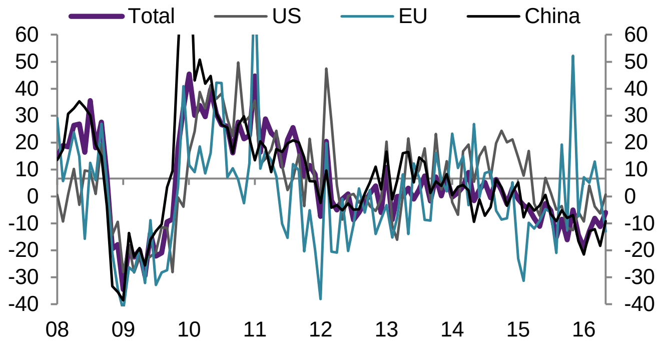
Source: Bloomberg, Natixis

Chart 4
JPYKRW abd EURKRW



Source: Bloomberg, Natixis

Chart 5
Korea's Exports to Major Countries (%YoY)



Source: CEIC, Natixis

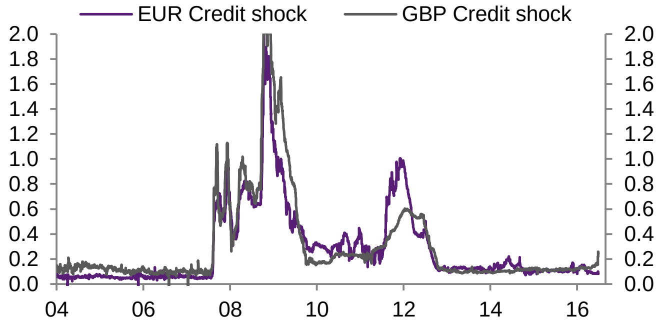
Chart 5 shows that Eurozone demand has not been a great help this year, despite better growth performance. The US is the only brightspot for Korea. Thus, a marginally expected growth slowdown in 2017 isn't likely to have a major impact on Korean exports. Thus, from the trade perspective, President Park's comments seem overblown, as Korean exports have been under intensive pressures before Brexit.

Assessing the financial spillovers

Next, we take a look at the financial channel. Clearly, as one of the more liquid financial markets in the region, Korean assets will have more volatility. However, beyond the fluctuation in prices, we want to take a look at whether events in the UK and the EU will spillover to Korea's financial system, and ultimately the economy.

Despite the move in financial assets, the banking system in the UK and the EU do not show signs of credit shocks (**Chart 6**). The credit shock is calculated as the difference between the three month interbank rate and the overnight swap index (OIS) rate. The OIS rate represents the expected path of the risk free rate, while the interbank rate is affected by the credit quality of banks. Thus, the spread between the interbank rate and the OIS rate can be considered as a measure of credit risk in the banking sector (**Chart 6**). We use the spread in the UK and the EU to measure credit shocks. In contrast to previous crisis, the banking system in the EU does not exhibit signs of credit shock, although the UK does show a small jump. This means that the spillover to Korea's financial system is likely limited.

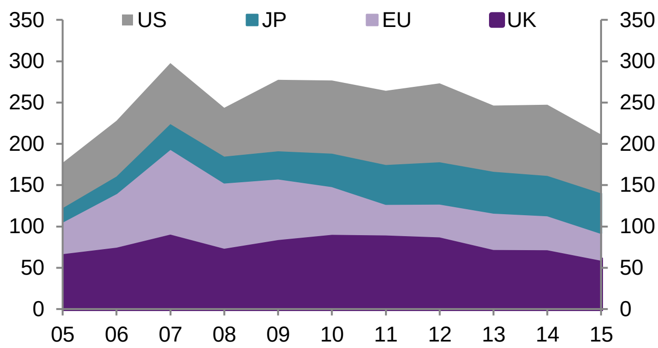
Chart 6
There is a slight uptick of credit shock for the UK
(3mLibor - 3mOIS)



Source: Bloomberg, Natixis

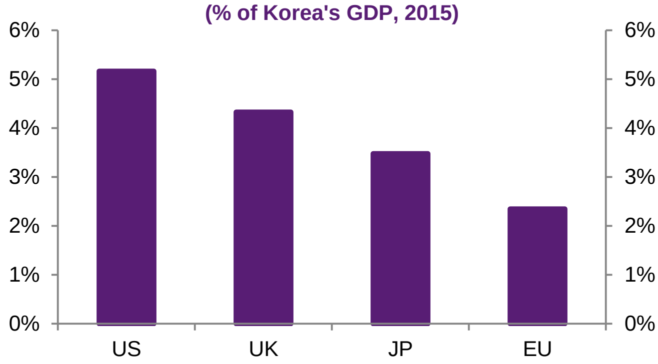
But we want to consider the risk to Korea should a credit shock occur in the UK and the EU. **Chart 7** shows claims on Korea by banks from the US, Japan, the EU and the UK. Foreign claims on Korea have actually declined over the years, limiting the risks of capital withdrawal as they have already been the trend. The US and the UK have the largest claims on Korea and their claims have been declining as well. **Chart 8** shows the share of claims to GDP – the UK's claims made up 4.3% of GDP end 2015. The EU's claims are much smaller at 2.3% of GDP or USD32.4bn.

Chart 7
Claims on Korea by Major Countries (USD bn)



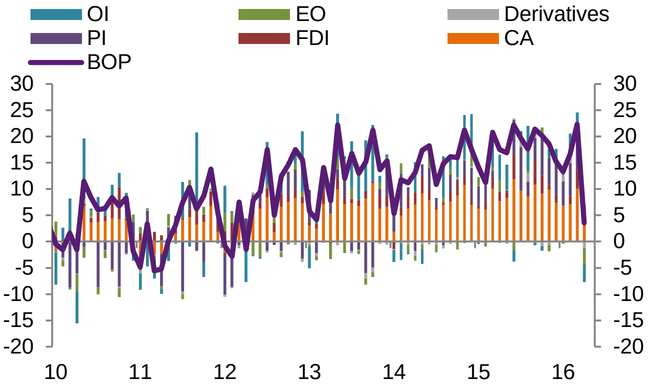
Source: BIS, Natixis

Chart 8
Total Claims on Korea
(% of Korea's GDP, 2015)



Source: BIS, Natixis

Chart 9
Korea's balance of payment positions (USDbn)



Source: CEIC, Natixis

Should global liquidity conditions tighten and banks withdraw capital to their home country, the impact on Korea should be small from the EU's perspective. However, should the credit shock worsen significantly for the UK, it will spill over to Korea given larger claims. Therefore, from a financial perspective, President Park is not exaggerated to warn of potentially further downsides. **Chart 9** shows that the balance of payment (BOP) deteriorated recently, but still positive.

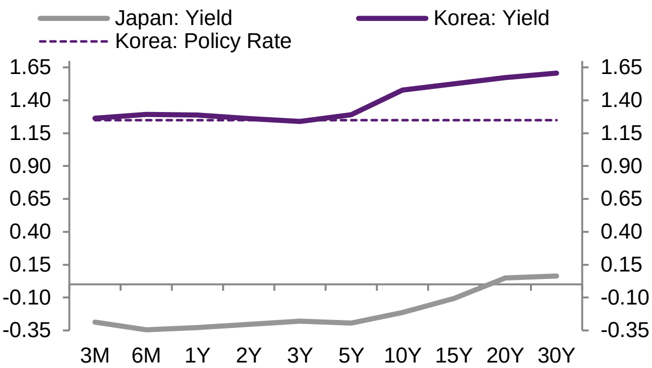
Policy and growth implications

We believe that the small size of the additional fiscal stimulus paves way for another 25bps rate cut by the BOK. Clearly, although President Park is concerned about downside risks to growth, she is not frightened. As a result, the additional stimulus that she actually announced today is really just an additional KRW10trn or just 0.6% of GDP. Her reluctance reflects the fact that while Brexit poses downside risks for Korea, the risks are still manageable and nothing out of the on-going trend of both weak trade and less bank lending to Korea. And given the marginal downside risks and the government general reluctant to use fiscal policy to support growth, we believe the baton is passed on to the BOK to assist.

We believe the central bank will make the leap and cut rates by another 25bps to 1% even as soon as the 14 July meeting. Governor Lee stated, "BOK to put in efforts to minimize impact from Brexit and negative impact from Brexit is inevitable for Korea." This means that the BOK will use this as a catalyst to deliver one last cut for the year in Q3 2016. And markets are starting to price in another cut. **Chart 10** shows Korea's government yield curve versus the policy rate (1.25%) and Japan's deeply negative sovereign yield curve.

We believe that subdued inflation outlook and relatively decent yield (in comparison to Japan's) as well as the Fed is likely to delay the rate hike should give the BOK some comfort to slash rates by 25bps in Q3 2016.

Chart 10
Yield Curve and Policy Rate (%)



Source: Bloomberg, Natixis NB Rate as of 28 Jun 2016

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