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Korea Watch

Year Ahead 2024: Export-led cyclical recovery on the way

23 November 2023

GEM Economics
Asia | Korea

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Abbreviations
BoK: Bank of Korea
DSR: debt service ratio
KTB: Korea treasury bond
MoEF: Ministry of Economy and Finance
s.a.: seasonal adjusted
UST: US treasury bond

Growth: Export-led cyclical recovery on the way

Korea exports growth has turned around lately. We expect such momentum to sustain throughout 2024, with the help of: 1) the tech-cycle rebound; 2) the US capex cycle upturn & stabilized China demand; and 3) easing stance from major central banks. Given the significance and spillover of the exports sector, we expect the external tailwind to boost both domestic consumption and investment; hence, see a healthy and balanced recovery in 2024. Specifically, we forecast GDP will grow to 2.3%/2.5% in 2024/25.

Inflation: Expect core CPI reaching the target by mid-2024

Headline CPI inflation is likely to moderate to 2.3% yoy in 2024, after an above-target 3.6% in 2023. Despite the recent upside surprises in inflation, we remain confident that the inflationary pressure will ease going forward, as the core inflation has been moderating continuously. Specifically, we expect core inflation to moderate to sub-2% by mid-2024, providing favorable disinflationary condition for the BoK.

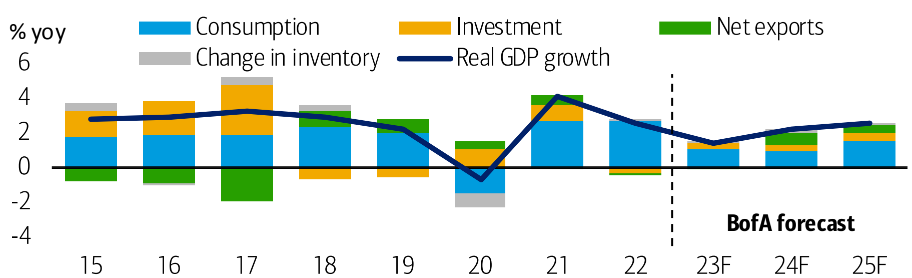
Policy: BoK may cut ahead of the Fed in this easing cycle

Monetary policy is likely to be more accommodative. We expect the current unfavorable domestic (higher inflation) and external factors (higher rates and FX pressure) to fade in 2024. Hence, believe the BoK will ease from its current restrictive stance. We have penciled in three cuts by the BoK from May 2024 the earliest, with 25bp in each following quarter in 2024. We also expect one more cut in 1Q25 with a terminal rate of 2.5%. Meanwhile, we see a prudent fiscal policy next year, with lower fiscal expenditure growth as well as lower fiscal deficit in 2024 to rein in debt growth.

Risks: Largely balanced on the either side

The risks are largely balanced on both our growth and inflation outlook. A **bull scenario** includes: 1) more proactive policy support in China to boost growth; 2) a stronger-than-expected recovery in global semi and tech demand. On the other hand, a **bear scenario** is likely due to: 1) the paring of the manufacturing cycle recovery; 2) the higher commodity prices that warrant a more hawkish BoK; and 3) elevated household leverage.

Exhibit 1: Real GDP forecast by expenditure
We expect Korea to grow 2.3% in 2024, with higher growth contribution from net exports



Source: Haver, BofA Global Research estimates

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Refer to important disclosures on page 8 to 9. **12630899**

Timestamp: 22 November 2023 03:30PM EST

External headwind seen as a major drag to 2023 growth...

Korea faced tough headwinds on economic growth in 2023, in which we expect only a growth of 1.4% yoy, notably below the trend growth. The major drag came from the external sector, as exports contracted significantly in 1H23 from the weak China demand amid a downturn in the tech cycle. Meanwhile, the domestic economy faced sustained pressure from the high-rate environment, as the BoK plans to keep the rate at 3.5% throughout the year to curb inflationary pressure and stabilize debt growth. This has led to a sharp correction in the housing market in 1H23 and cracks in the financial market, especially on property financing. And the housing market has only been able to stabilize in 2H23 with the help on eased housing policies. In terms of domestic consumption, household consumption largely held up well with the help of the excess savings during the Covid period as well as the tight labor market, but the sentiment has weakened, and the higher DSR continued to weigh on consumption.

...while export-led cyclical recovery is on the way

That said, we have seen more green shoots in the economy recently, suggesting a healthy growth rebound is in sight.

More green shoots in cyclical upturn

In 3Q23, Korea's GDP growth momentum has maintained at 0.6% qoq s.a, with a sequential acceleration in investment and improved exports growth. In Oct, monthly export growth had further picked up to 5.1% yoy, in the positive territory first time in 13 months. Industrial production has rebounded on better semi sector IP growth. The housing market also stabilized, with price and volume improving from the bottom (see: report).

Exhibit 2: Major economic indicators for Korea

We expect Korea GDP to rebound to 2.3%/2.5% in 2024/25

		2019	2020	2021	2022	2023F	2024F	2025F
GDP by expenditure								
Real GDP growth	% yoy	2.2	-0.7	4.3	2.6	1.4	2.3	2.5
Final consumption expenditure	% yoy	3.2	-2.2	4.1	4.1	1.6	1.4	2.3
Gross capital formation	% yoy	-2.1	3.5	3.2	-0.5	1.5	1.5	1.8
Contribution to GDP growth								
Net exports	pp	0.8	0.4	0.6	-0.1	-0.2	0.6	0.5
Major activity indicators								
Household consumption	% yoy	2.1	-4.8	3.6	4.1	1.8	1.7	2.5
Construction investment	% yoy	-1.7	1.5	-1.6	-2.8	2.7	1.5	-1.3
Facility investment	% yoy	-6.6	7.2	9.3	-0.9	-0.8	1.4	5.8
Intangibles investment	% yoy	3.1	3.4	6.1	5.0	1.7	1.5	2.8
Exports of goods	% yoy	-1.1	-0.2	10.7	3.6	2.5	5.9	5.9
Import of goods	% yoy	-2.5	0.3	12.6	4.3	-0.4	2.9	5.3
Trade balance	US$bn	79.8	80.6	75.7	15.1	30.5	64.3	71.6
Current account	% of GDP	3.6	4.6	4.7	1.8	1.7	2.0	1.9
Key price and policy indicators								
CPI	% yoy avg	0.4	0.5	2.5	5.1	3.6	2.3	2.0
BoK base rate	% year-end	1.25	0.50	1.00	3.25	3.50	2.75	2.50
USDKRW	year-end	1,158	1,088	1,186	1,267	1,300	1,230	1,240

Source: Haver, BofA Global Research estimates

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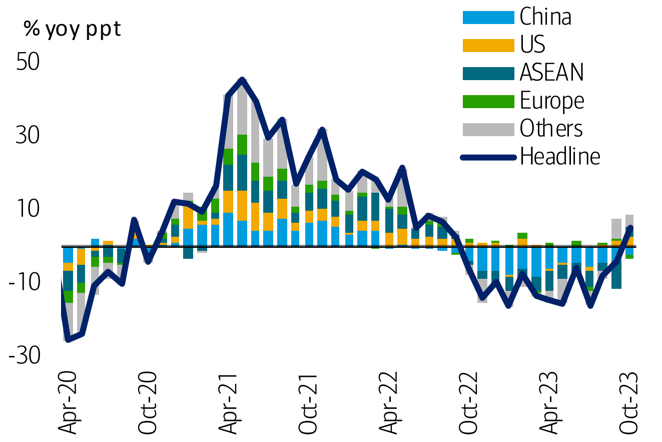
Given the significance of the exports sector in Korea, as well as its spillover effect on the domestic economy, we see a healthy and balanced recovery in 2024. We forecast the economy will grow to 2.3% in 2024, and expect net exports to see a notable pick-up in this cyclical recovery (see also: Korea viewpoint). Specially, the support should emanate from: **1)** the tech-cycle rebound amid memory chips price recovery (Exhibit 4); **2)** the US capex cycle upturn and stabilized China sequential growth momentum (see also: China Economics Year Ahead 2024); and **3)** eased pressure of further tightening in the global central banks (our global economists expects three cuts from the Fed starting June 2024, and most major central banks to ease in 2024; see: Global Economics Year Ahead 2024).

Moreover, we also expect this export turnaround to translate into a tailwind to both domestic consumption and investment, as we have observed strong positive spillovers from the external sector to domestic economy in the past.

Exhibit 3: Exports by region

Exports to US and ASEAN have been robust in Oct, offsetting weak demand from China



Source: Haver, BofA Global Research

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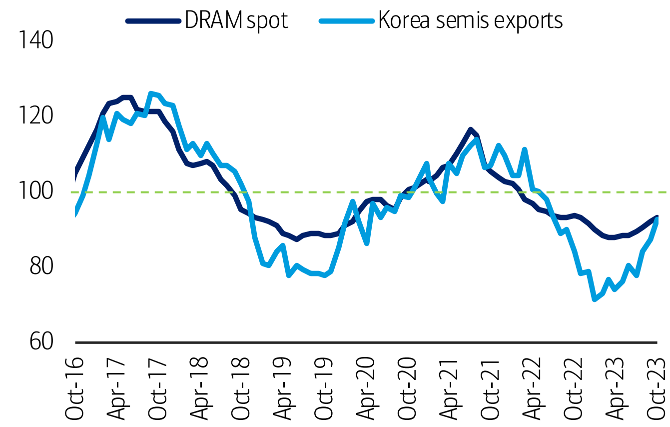
Exhibit 4: DRAM spot vs Korea semis exports

Korea's export recovery is supported by both volume and value of semi exports



Source: DRAMeXchange, MoTIE, BofA Global Research

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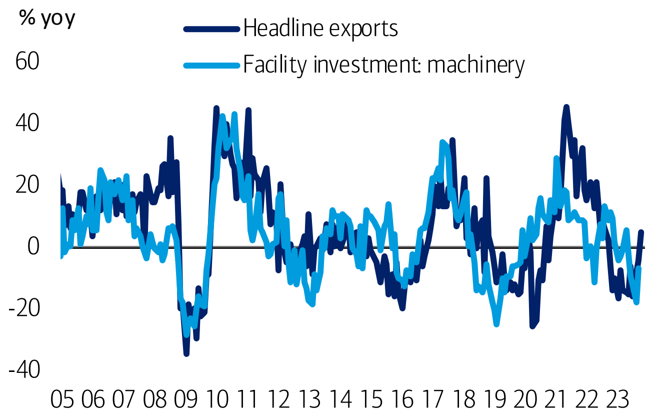
Export turnaround = stronger capex

The more direct channel will be on facility investment, in our view. In Korea, around 30% of gross fixed capital formation, or 10% of GDP, are facility investment, including investment on transport equipment and general/specialized machineries. As the key exporting sectors (semiconductor, automobile, shipbuilding, chemical industries, etc.) in Korea are highly capital intensive, facility investment will usually move in tandem with the exports cycle. In the past decades, correlation between facility investment and headline export has been high at around 0.6 (Exhibit 5).

This time around, we expect the upturn of tech cycle, as well as the increasing manufacturing capex amid eased financial conditions, to help support the growth in the near term. Specifically, our tech analysts expect a double-digit growth in capex on DRAM/NAND production capacity in 2024. We also believe the continued expansion in electric-vehicle production capacity from major automakers will contribute to higher facility investment, although we also note their efforts to build production capacity overseas. Overall, in real terms, we expect facility investment to turn around notably in 2H24 to 4.4% yoy, from -1.6% in 1H24 and the low year-ago base from 2H23.

Exhibit 5: Export and facility investment
Facility investment is highly correlated with export growth…



Source: Haver, BofA Global Research

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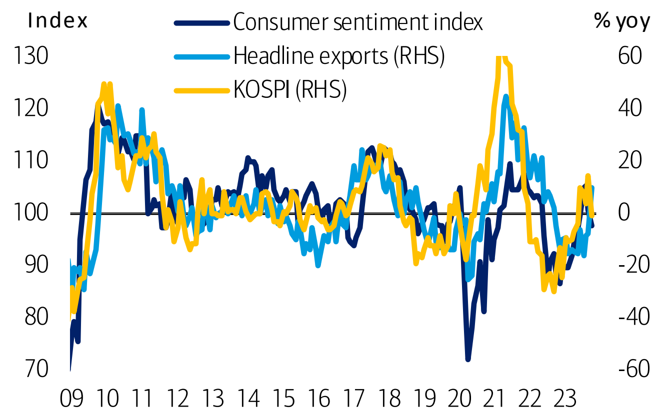
Exhibit 6: Export, equity performance and consumer confidence
Historically, the correlation between export growth and KOSPI performance has been as high as 0.95; higher export will also boost consumer sentiment



Source: Haver, BofA Global Research

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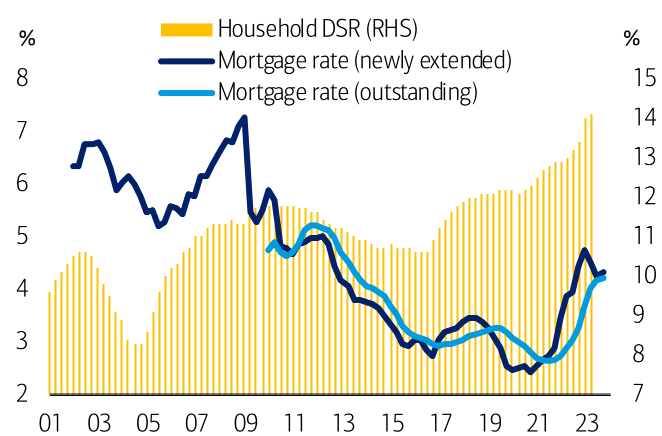
Export turnaround = better corporate earnings & stronger consumer confidence

Indirectly, the stronger external sector will also boost consumer confidence, mainly via wealth effect. Although the majority of employment are not directly related to exporting sectors, we note that the equity performance is highly correlated to export performance (Exhibit 6), as most of the largest capped listed companies in Korea are also the largest exporters in Korea. As export performance improves, we expect it to translate into better earning growth (hence potentially better equity market performance), so that consumer confidence is likely to improve. Although the overall consumption will still be dampened by the high DSR (Exhibit 7), as well as the high rate to weigh on durable and discretionary goods consumption, we believe the export-rebound positive spillover could partly offset the drag, and expect household consumption to grow at 1.7% yoy, largely flat with that of 2023.

Exhibit 7: Mortgage rate and debt service ratio
Higher mortgage rate led to higher household debt services from 2022



Source: Haver, BofA Global Research

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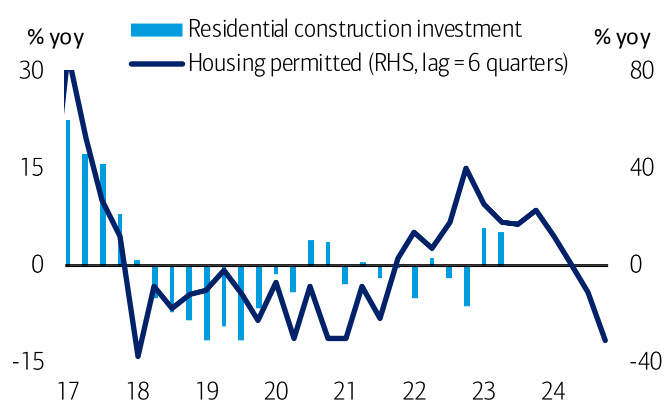
Exhibit 8: Construction investment vs housing construction permitted
Contraction in housing permitted suggests a moderation in construction investment going forward



Source: Haver, BofA Global Research

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Construction activities likely to moderate

Separately, within the investment, we expect construction investment to soften in 2024, especially from the second half. Year-to-date, construction investment remained resilient at 14.2% yoy despite the housing market downturn. This was mostly due to the high new home starts (housing permits) between 1Q21 and 3Q22. However, past cycle suggests that the housing permitted has led the construction activities by 18 months

(Exhibit 8). Given the lagged impact, we expect the construction investment (accounted for 20% of the investment in 2022) to moderate going forward, and may start to be a negative drag on growth from late-2024. That said, the potentially eased financial conditions may help to alleviate the drag, in our view.

Overall, despite the headwinds, we see a stabilized and robust sequential economic growth path in 2024 and foresee a more balanced growth contribution from private consumption, facility investment as well as net exports in 2024 (Exhibit 1).

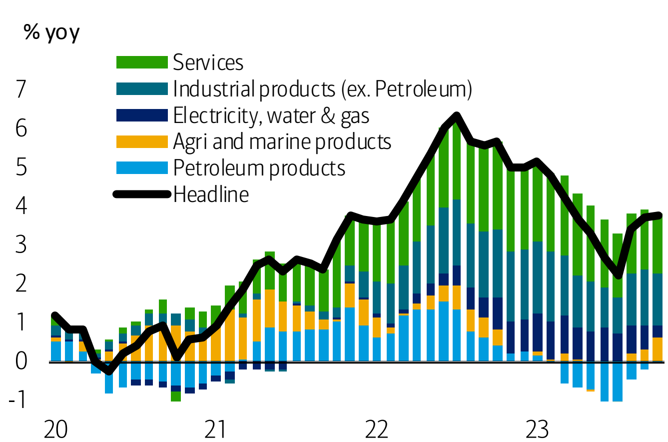
Inflation: Expect core CPI reaching the target by mid-2024

In Oct, headline CPI inflation rebounded to 3.8% from 3.7% previously on food & energy inflation, which was a surprise to both the BoK and the market (Exhibit 9). That said, we remain confident that the inflationary pressure will ease going forward, as the core inflation has been moderating continuously. Specifically, private services inflation, the stickiest part, was softening sequentially from peak level in most of the months lately.

In terms of energy and utility prices, admittedly, the outlook remains much dependent on geopolitical developments, especially the recent incident in the Middle East. Our base-case scenario sees no significant escalation of the conflict, and we expect Brent crude oil prices to moderate through 2H24 (from US$92/bbl in 2Q24 to US$88/bbl by 4Q24). For utility prices, we do expect price hikes in 2024 after the inflation pressure eases. However, the room for further hikes may be limited, in our view, as the government is alerted on the rise in cost-of-living among households. In early Nov, policymakers announced they will set up taskforces to monitor inflation of key products.

In all, we remain confident that the inflation is under control, and expect the disinflation trend to continue in both headline and core inflation in 2024. We forecast average headline CPI inflation will moderate to 2.3% yoy next year (from 3.6% in 2023), with further stabilization in the price level to 2.0% in 2025. On a monthly basis, we expect the two measures of core inflation both to reach around 2% level by May 2024, and the headline to come in around 2.5% by that period (Exhibit 10), and ease further towards the target (of 2%) by early 3Q. This, in our view, would potentially provide a favorable disinflationary environment for the BoK by mid-2024.

Exhibit 9: Monthly CPI inflation breakdown
Oct headline inflation rebounded on food & energy inflation



Source: Haver, BofA Global Research

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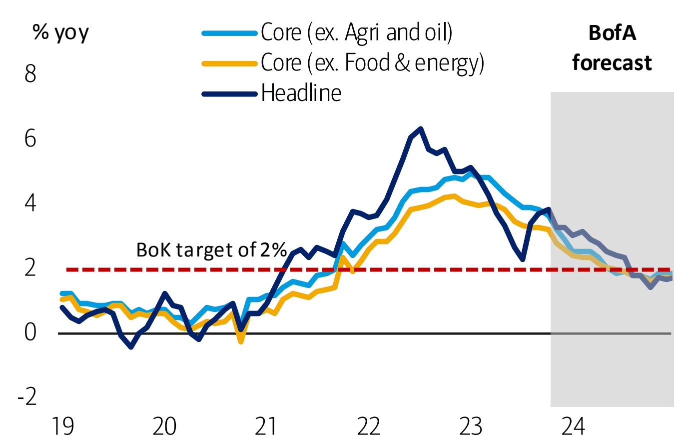
Exhibit 10: Monthly CPI inflation forecast
We expect average headline CPI inflation to moderate to 2.3% yoy in 2024



Source: Haver, BofA Global Research estimates

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Policy: Combination of fiscal prudence & monetary easing

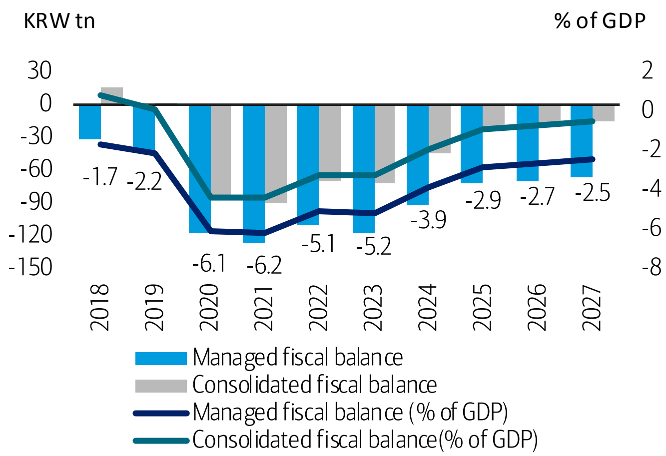
Fiscal prudence to continue

After a challenging year for fiscal management in 2023 (see also: [Budget plan commentary](#)), we expect the current administration's fiscal policy to remain relatively conservative, as outlined in the 2024 Budget. Especially, the fiscal spending is set to rise only by 2.8% yoy in 2024-the lowest increase since 2005. Meanwhile, the administration also announced a more conservative KTB issuance plan (Exhibit 12), which reaffirms its commitment to rein in debt growth after a massive rise during the pandemic. As such, we do not envisage any supplementary budgets without an expected crisis-like event.

That said, although the 2024 fiscal deficit target is likely to be lower than this year (3.9% vs. 5.2% in 2023), it is still relatively higher than the pre-pandemic level, and there could be pressure on more transient spending before the parliamentary elections in April 2024, in our view.

Exhibit 11: MoEF fiscal balance forecasts

Fiscal policy is expected to consolidate in 2024-27



Source: MoEF, BofA Global Research

Note: 2023 number is revised based on the latest revision on expected tax revenue by MoEF

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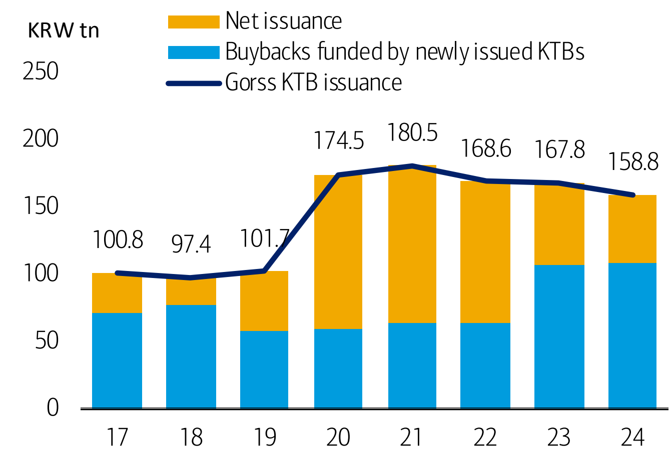
Exhibit 12: Annual KTB issuance and plan for 2023 & 2024

Gross issuance to moderate in 2023 and 2024



Source: MoEF, BofA Global Research

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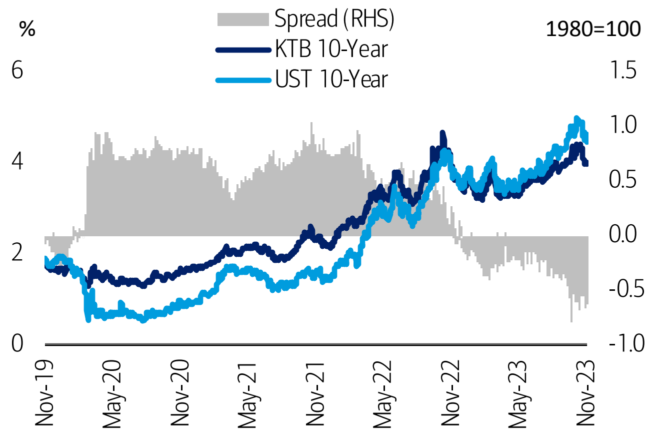
Expect BoK to ease from late-2Q

Year-to-date, although the BoK has been on hold on the benchmark rate since February 2023, it has maintained a relatively hawkish stance on the back of unfavorable domestic and external factors, namely: high domestic inflation, high household leverage ratio, widened US-Korea rate differentials (and weaker KRW), as well as the oil price rebound amid geopolitics tension. That said, we note that most of the headwinds are likely to fade in 2024. Hence, we expect a more accommodative monetary policy in 2024, and have pencilled in three cuts during the year, with 25bp in each quarter.

A lower inflation and eased Fed may warrant the first rate cut in May. In our view, the first cut could come as early as the BoK's meeting in May 2024. Domestically, under our expected inflation trajectory, we note the core inflation will soften to about 2% in 2Q, and the headline inflation may also return to around 2.5% level. This would signal an eased domestic inflation pressure towards the policy target rate. Externally, UST yield likely peaked, and the Fed should have been done with hiking and should have paused for multiple months, with little financial market volatility. Thus. we see the first cut in May 2024 as a likely scenario, even if it will be ahead of the Fed. We also pencilled in one more cut in 2025, with the terminal rate at 2.5%, slightly higher than the estimated neutral rate (of 2-2.5%). Overall, we see a relative favourable monetary condition in 2024, especially in 2H.

Exhibit 13: 10Y UST and KTB yield differential
US rates have likely peaked, narrowing the rate differential from the peak



Source: Haver, BofA Global Research

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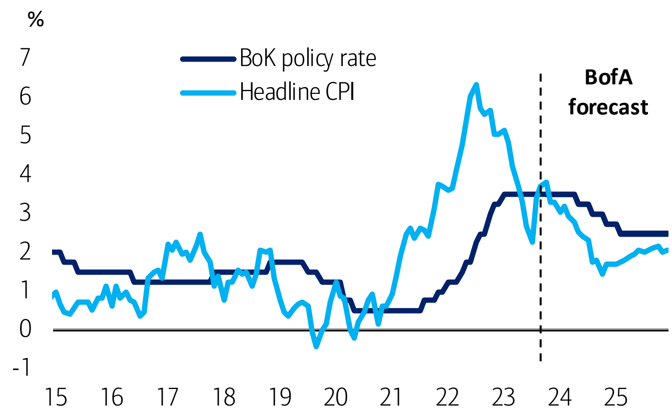
Exhibit 14: Headline CPI vs BoK policy rate forecast
We expect BoK to start cutting rates from 2Q24 on falling inflation



Source: Haver, BofA Global Research estimates

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Exhibit 15: MPC meeting and release schedules in 2024
Policy meetings held in first two months of the quarter; minutes released after three weeks

	Monetary policy meeting	Monetary policy minutes	Submission of reports to Parliament
Jan	Thursday, 11 Jan	Tuesday, 30 Jan	
Feb	Thursday, 22 Feb	Tuesday, 12 Mar	Monetary Policy Report
Mar			
Apr	Friday, 12 Apr	Tuesday, 30 Apr	
May	Thursday, 23 May	Tuesday, 11 Jun	
Jun			Monetary Policy Report, Financial Stability Report
Jul	Thursday, 11 Jul	Tuesday, 30 Jul	
Aug	Thursday, 22 Aug	Tuesday, 10 Sep	Monetary Policy Report
Sep			
Oct	Friday, 11 Oct	Tuesday, 29 Oct	
Nov	Thursday, 28 Nov	Tuesday, 17 Dec	
Dec			Monetary Policy Report, Financial Stability Report

Source: Bank of Korea, Bloomberg
Note: quarterly macro forecasts are due Feb, May, Aug and Nov 2024

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Risks: Largely balanced on the either side

The risks are largely balanced on both our growth and inflation outlook.

On the bright side: **1)** a more proactive China policy support should likely boost external demand for Korea exporters; **2)** in the case of stronger-than-expected recovery in global semi and tech demand, external sector in Korea will likely provide an additional boost to the domestic economy.

On the other hand: **1)** any upside surprise to keep the Fed stay higher for longer could hurt consumer and capex demand in the US, paring the current recovery in the manufacturing cycle; **2)** the alternative scenario where commodity prices go higher, the BoK could face pressure to hold rates for a longer period to stabilize the non-core inflation; and **3)** the higher household-leverage ratio amid housing market stabilization could potentially constrain the BoK to ease from its current restrictive policy stance.

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