Another key risk stems from the Russia-Ukraine conflict. South Korea has joined efforts to sanction Russia. The country was Russia’s largest trade partner in Asia after China. Russia accounted for 2.2% of South Korea’s total trade with the latter’s exports comprising mainly cars and machinery while South Korea imported mostly oil, seafood and iron/steel from Russia.

The largest impact is expected to come in the form of significant pressures on inflation as global energy and food price rise which may drag private consumption and external demand if prices stayed elevated for the rest of the year. The high energy and raw material import bill also weighs on the country’s trade balance, seen in the record trade deficit in Jan. This will contribute to the narrowing of the current account surplus and increase South Korea’s vulnerability to external volatilities. The Bank of Korea (BOK) has upgraded its 2022 inflation forecast sharply to 3.1% from 2.0%. We now see further upside risks and therefore adjust our forecast to 3.3%. Headline inflation will likely stay above 3% through the first three quarters of 2022.

Fiscal policy has remained expansionary to cushion the economy from higher growth risks. President-elect Yoon Suk-yeol has campaigned on jobs and housing issues, and will be expected to introduce more stimulus measures after taking office in May. South Korea has already passed its first supplementary budget of 2022 on 21 Feb. The amount of KRW16.9 tn (0.8% of GDP) will be used for compensating losses for small businesses, relief payments and to support COVID-19 control measures. This is expected to bring the projected fiscal deficit to more than 3.3% of GDP for 2022.

Taking into account of the increased near-term growth risks, we have downgraded our forecast for South Korea’s 2022 GDP growth to 2.7% from 3.0% previously. We expect GDP growth to moderate to 2.6% y/y in 1Q22 and 2.4% y/y in 2Q22 before recovering to 2.9% y/y in the second half of this year.

CENTRAL BANK

BOK To Hike By Another 50-75 bps This Year

The BOK has hiked its benchmark base rate three times, by a total of 75 bps since Aug 2021 to restore the rate to its level before the pandemic at 1.25%. Although concerns over financial imbalances have slightly abated, the higher commodity and food prices which may be further exacerbated by supply disruption has underpinned expectations that the BOK will resume its rate normalisation in Apr/May. Governor Lee Ju-yel said that the degree of monetary policy accommodation has grown with stronger inflation. Having said that, we note the current view may not hold for future meetings as the new governor takes office.

Our base case remains for 25 bps hike each in 2Q and 3Q to bring the base rate to 1.75% by 3Q but the higher inflation risk may warrant a further 25 bps increase in 4Q (not in our base case yet).

CURRENCY

KRW Still Biased Weaker

Being a high beta currency sensitive to global growth expectations, the KRW has taken a beating after the Russia-Ukraine conflict exacerbated inflationary pressures and dimmed the global growth outlook. USD/KRW broke out of its key resistance at 1.212 and went straight to 1.240, the highest level in almost two years. Other domestic headwinds denting sentiments on the KRW include the South Korea’s lingering economic restrictions amid a high vaccination rate. More than 86% of the population received two vaccine doses while around 62% of the population had booster shots. The presidential election went ahead in Mar despite high daily caseloads and fully vaccinated foreign visitors may be exempted from mandatory quarantine from 1 Apr. The reopening of borders will help to drive a more sustained rebound in private spending this year, subject to the government’s ability to keep local infections under control. The current pandemic outbreak in China, its largest export market, may however contribute to weaker demand outlook for South Korea in the near-term.