

Korea Macro View

2012 Presidential Election and Macro Policy Implications

- **Opposing camps decided to merge candidates earlier than expected** — Moon, of the main opposition Democratic United Party, and the independent Ahn agreed to unify their presidential candidacy before 25 Nov. The agreement was widely expected since the odds for a change of government are higher when they ally rather than running separately. According to recent polls, Park leads both Moon and Ahn if they all compete for the presidency, but the results for Park vs. Moon or Park vs. Ahn are neck and neck. With the agreement, one of the main uncertainties about Dec's Presidential election has been removed and the race will practically be a two-way: Park vs. a single candidate from the opposition (Moon or Ahn).
- **Policy competition seems to be heating up** — Economic democratization is the top of the agenda of all three candidates. The candidates seem to propose more appealing policies to take an advantageous position first in the election or in determining a single candidate. We expect Park and an allied opposition group will compete on two aspects: 1) Political reform including constitutional amendment for two-term presidential system, and 2) measures to alleviate economic difficulties of the people. The latter is likely to lead the candidates to lean further towards populist policies.
- **Whoever wins, the economy is likely to remain weak for a while** — We think the economy will remain weak growing at 2% levels on year-on-year terms until 1H13 due to sluggish domestic demand and lukewarm export growth. In particular, continued contractions of construction and facilities investment will damage economic growth potential and are likely to push the new government to consider boosting measures, such as relaxing housing market regulations and providing more tax incentives, in our view. However, we anticipate a gradual but visible economic rebound in 2H on the back of improvement in the global economy, which will lead to recovery of exports and facilities investment. If this base scenario is true, the government may not implement an additional budget, i.e. a supplementary budget, but would have to reenact budget frontloading in 1H to offset a decline in contribution of government spending to growth caused by base effects.
- **Rapid economic reform is unlikely but we see another rate cut early next year** — The BoK will likely keep the policy rate unchanged this year, despite economic growth below the potential level and headline inflation at a low 2%. However, we expect the BoK to cut the rate by 25bps early next year along with the government's boosting measures. However, we expect it will maintain the policy rate at 2.5% to the end of 2013 but will likely warn of acceleration of inflation in 4Q13. We think the BoK will begin to allude rate normalization at the end of next year and raise the rate in later 4Q13 at the earliest. On KRW, FX authorities are expected to intervene in the market more actively to slow down the pace of appreciation in order to support the export sector and job growth in the manufacturing sector.

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Presidential Election and Policy Implications

One of the main uncertainties of the presidential election on 19 Dec has been resolved as the major opposing camps agreed to decide on a single candidacy before the registration period for presidential candidate, 25-26 Nov. By the agreement, either Moon from the DUP or the independent Ahn will be a candidate to compete with Park from the Saenuri Party to be the 18th president of Korea. We expect policy competition to heat up as they will strive to take an advantageous foothold during the remaining campaign period on two aspects: policy reform and a populist policy agenda. We think the economy will remain sluggish regardless of who wins the election in Dec given sluggish domestic and external demand, unless the new government provides boosting measures. However, we think a large-scale supplementary budget is not likely since the economy is expected to show visible signs of a rebound in 2H13 due to the gradual improvement of the global economy and low base a year ago. The new government will possibly frontload its budget, as it did in 2012, and might relax some of the regulations on the housing market and corporations to spur housing market and facilities investment. We reiterate our view of no policy rate change in this year but another and last rate cut in early 2013. On the foreign exchange rate, the authorities are likely to intervene in the market more actively than they have recently after the election to support exports and growth. Further tightening of macro prudential measures would be no surprise if appreciation of KRW outpaces other EM currencies.

Moon and Ahn agreed to unify candidacy

On 6 Nov, two presidential candidates, Moon Jae-in of the main opposition Democratic United Party (DUP), and an independent runner, Ahn Cheol-soo, had a closed meeting in Seoul at 6pm and agree to unify candidacy for the 19 Dec presidential election. They announced seven agreements after the meeting, including the decision to establish a single candidacy before the registration period for presidential candidates (25-26 Nov) and a joint declaration of political reform. The decision to offer a single candidate came a bit earlier than we had expected, which was after the registration period. However, it is not totally surprising since both Moon and Ahn know that they might lose the election if they compete against each other or their decision on a merger was delayed. According to recent polls listed in Figure 1, their approval ratings are lower than the rating of Park Geun-hye from the ruling Saenuri Party. However, the polls show that the approval ratings for a unified candidate vs. Park are neck to neck when either Moon or Ahn is the single candidate. Therefore, it was widely expected that Moon and Ahn would form an alliance and elect a single candidate to compete with Park. However, it is not clear for now whether the single candidate will be elected smoothly, since the two contenders have not agreed on how they will form a political alliance and decide the unified candidate yet. Furthermore, Ahn's camp request that the declaration of political reform, which includes a reform of Moon's DUP, should come first before discussing the method of the candidacy merger.

Figure 1. Approval Rating of Three Major Presidential Candidates

Polling Institutions	Survey Period	Three-way Race			Two-way Race				Race for Single Candidacy	
		Park	Moon	Ahn	Park	Moon	Park	Ahn	Moon	Ahn
Gallup	Oct 29-Nov 2	38.0%	22.0%	25.0%	46.0%	45.0%	46.0%	46.0%	44.0%	39.0%
Realmeter	Nov 6	43.1%	23.8%	26.7%	46.3%	46.9%	45.1%	46.9%	38.3%	40.8%
KBS /Media Research	Oct 30	35.5%	22.9%	23.9%	45.9%	46.4%	43.1%	48.3%	45.3%	38.3%
MBC /Hankook Research	Oct 18	38.9%	20.6%	27.2%	44.7%	43.9%	42.9%	46.5%	41.0%	39.1%
SBS/TNS	Nov 2-4	N.A.	N.A.	N.A.	48.3%	44.6%	44.7%	49.2%	N.A.	N.A.

Source: Asia Economy Daily, Realmeter, JoongAng Daily, Newspim, Chosun Ilbo, Citi Research

The demand for political reform is more burdensome for Moon as he has to spur his party's political reform and persuade his colleagues to participate in such reform.

The following are what Moon and Ahn have agreed on:

1. The two candidates had in-depth discussions on stringent economic times and circumstances, the exhausting life of the people and the public's demand for political reform.
2. New politics and political reforms are needed to break up the powers of central party organizations, and the first step would be abandonment of the political circle's vested rights.
3. The single candidacy is in order to win the presidential election and have the two candidates' values and philosophies unified.
4. To push the merger forward, the two should not quibble over the advantages/disadvantages of each candidate but fulfill the people's aspirations for new politics and a turnover of political power. They also agreed that the public's sympathy and consent are material.
5. They will decide on a single candidate before the registration period for presidential candidate (25-26 Nov) and further discussions will take place to achieve this.
6. A joint declaration of political reform which includes reforms within the DUP and measures for an alliance to change government should be presented. As a first step towards joint declaration, both agreed to form a working group which will be comprised of six members, three from each camp.
7. Both candidates will work together to extend voting hours.

Meanwhile, independent Ahn feels less burdened, given his thin political background, organisation and support, which could be Ahn's weakness if political machine power affects the method of determining a single candidate. According to *Korea Herald* (Nov 2), Ahn's camp prefers a public opinion poll while Moon's camp favors an open primary, in which the DUP's organization power can play an important role. Given the short timetable till the deadline of registration, both side might have little time to prepare for open primary. However, both sides do not rule out the possibility of Moon and Ahn settling who will run as the single candidate at a separate meeting. In our view, the whole process of choosing a single candidate may depend on how the DUP takes the initiative and sets an example for a political reform, which might not be smooth as expected due to some critical issues. One of the issues would be the fierce opposition of DUP members to Ahn's proposal of reducing the number of total members of the National Assembly, from the current 300 to 200, as a cornerstone of political reform.

Policy competition to heat up

On the day when Moon and Ahn agreed to unify candidacy, Park announced her political reform proposals: a constitutional amendment for two-term presidential system, a reform to enhance natural rights of people and the abolition of political party's nominations of candidates for local governments and members of the National Assembly. The constitutional amendment for a two-term presidential system is also proposed by Moon of DUP. The current five-year one-term presidential system was introduced in the constitutional revision in 1987 to prevent

dictatorship, but it has been criticized as an irresponsible system which cannot guarantee continuity of policies. However, Ahn is less enthusiastic on that revision since he has the view that the discussion of any such revision should be based on the agreement of the people, according to *Joongang Daily* (Nov 7). Figure 2 lists each candidate's policy agenda for different areas. Besides the political reform, the candidates are all focusing on economic democratization and social welfare reform. Their pledges for economic democratization are centered on restraining the concentration of Chaebol's economic power, enhancing economic fairness and supporting SMEs and small businesses. The two rival's pledges are pretty much similar to each other but vary in the degree of restrictions. The welfare reforms they are promising are just extended versions of the ones proposed for the 19th National Assembly election in Apr, which were criticized as being populist. For inter-Korean relations, all the candidates seem to support resumption of talks between South and North Korea to reverse the current confrontation relationship. However, Moon, who inherited the Sunshine policy from a former president Roh Moo-hyun, is more active than the others in restoring inter-Korean relationships.

As the possibility of a three-way race in the Dec election is very low, Park may propose more appealing and stronger pledges than her previous ones given the tight competition in the two-way race between her and a united candidate (either Moon or Ahn). According to *Yonhap News* (Nov 7), Park is considering proposing so-called laws for large corporations (esp. Chaebol) which will unify all the existing laws for conglomerates and put on tighter restrictions -- such as preventing large corporations from entering SME business categories and a constraint on voting rights of existing circular investment. Despite agreeing the alliance, Moon and Ahn are likely to continue their own campaigns.

Figure 2. Policies and Pledges of Main Presidential Candidates

	Park Geun-hye	Moon Jae-in	Ahn Cheoul-soo
Political Reform	<ul style="list-style-type: none"> - Allowing re-election for 4 years of presidential term (two-term system) - Enact a special surveillance law to prevent corruption among presidential family members, relatives, aides and other political bigwigs 	<ul style="list-style-type: none"> - Two-term presidential system - Considers semi-presidentialism or parliamentary cabinet system desirable - Ban political retaliation and realize responsible politics 	<ul style="list-style-type: none"> - Grant prime minister extensive control of domestic politics and prevent concentration of president's power - Reinforce ethical standards for senior officials and avoid privileges of former post - Reduce members of the National Assembly to 200 from current 300
Economic Democratization	<ul style="list-style-type: none"> - Prevent excessive expansion of conglomerates and promote small- and medium-sized businesses - Restrict only new cross-sharing and oppose reintroduction of total equity investment ceiling 	<ul style="list-style-type: none"> - Ban cross-sharing and restore total equity investment ceiling - Reduce corporate tax cut and raise corporate tax for large enterprises 	<ul style="list-style-type: none"> - Enact a law on business groups to minimize harmful effect of conglomerates - Prohibit cross-sharing, restore total equity investment ceiling, strengthen the separation between industrial and financial capital
Welfare & Jobs	<ul style="list-style-type: none"> - Thinks welfare should be selective and customized to life-cycle stages - Extend free childcare to age 5, provide free high school education, support half of college tuition 	<ul style="list-style-type: none"> - Provide free meals, childcare and health service, and support half of college tuition - Promote virtuous cycle of welfare focused on job - Introduce unemployment assistant subject to job seeking 	<ul style="list-style-type: none"> - Blend universal and selective welfare strategically - Alleviate youth unemployment by job sharing and introduction of salary peak system - School meals and investment in education apply to universal welfare in principle
Inter-Korean Relations	<ul style="list-style-type: none"> - Need to reverse confrontation between South and North Korea to resume conversation - Pursue a Trust-building Process on the Korean Peninsula based on restored trust 	<ul style="list-style-type: none"> - Push ahead the inter-Korean summit and reunion of separated family members on the first year of presidential term - Propel economic union of South and North Korea 	<ul style="list-style-type: none"> - End armistice system and build peace regime - Resume tours to Mt. Geumgang and Gaesong, and expand Gaesung industrial complex

Source: Maeil Business Newspaper, Citi Research

Whoever wins, the economy looks to remain weak

What's unique in this presidential election campaign is that all the candidates assess current economic conditions as stringent but are not actively preparing boosting measures. Instead, they are emphasizing fiscal consolidation and refraining from expanding fiscal spending besides social welfare. The economy is expected to grow 3.4% in 2013 from the previous year, falling short of potential growth of 3.8% for three consecutive years (2011: 3.6%, 2012: 2.3%). We attribute this to sluggish demand, both domestic and external, in 1H13. Depressed economic sentiment due to worry on the economic growth path as well as lingering Eurozone financial stress, the US fiscal cliff and high level of households leverage, seems to prevent active recovery of private consumption expenditures in 1H. Exports will likely continue a gradual recovery in 1H but year-on-year growth is expected to remain at 1% levels as the recovery would not be strong enough to overcome the base effect. The aforementioned sluggish consumption and tepid export growth will lead contraction in facilities investments. However, we think the economy will show visible signs of recovery in 2H by growing 4.1%YoY on the back of improved global economic conditions – a steady rebound of economic growth in the US and Eurozone, and stabilization of housing markets as well as the low base of a year ago.

Our baseline scenario is that the global economy will expand by 3.2% in 2014 (vs. 2.7% in 2013), spurring facilities investment as well as exports. Both exports and imports will continue to show weak growth in 1H at low 1% levels on year-on-year terms, but will show high single digit growths in 2H as external and domestic demand recover. Trade surplus will likely narrow to US\$24.2bn, from an estimated US\$26.6bn in 2012, while current account surplus would shrink further as services account deficit widens on strong KRW. Despite a rapid rebound of the economy in 2H, 2013 annual growth would remain at 3.4%, still leaving a negative output gap and thus less inflationary pressures from the demand side. However, CPI inflation is projected to rise from 2.2%YoY in 1H to 3.2% in 2H due to low base in 2012 and a rise in public services prices.

Figure 3. 2013 Macro Forecasts

	2010 Annual	2011 Annual	2012							2013		
			1Q	2Q	1H	3Q	4QF	2HF	Annual F	1HF	2HF	Annual F
GDP (%YoY)	6.3	3.6	2.8	2.3	2.6	1.6	2.6	2.1	2.3	2.6	4.1	3.4
Private Consumption	4.4	2.3	1.6	1.1	1.3	1.5	2.5	2.0	1.7	1.8	2.4	2.1
Fixed Capital Formation	5.8	-1.1	4.6	-2.1	0.8	-2.0	-0.6	-1.3	-0.3	0.1	5.4	2.9
Construction	-3.7	-5.0	1.5	-2.1	-0.6	-0.1	-0.5	-0.3	-0.4	1.4	3.8	2.7
Facilities Investment	25.7	3.7	8.6	-3.5	2.2	-6.0	-2.3	-4.2	-1.0	-4.0	7.0	1.3
Exports of Goods & Services	14.7	9.5	4.7	3.2	3.9	2.6	5.6	4.1	4.0	4.3	5.9	5.1
Imports of Goods & Services	17.3	6.5	4.4	0.5	2.4	0.9	4.3	2.6	2.5	2.3	5.6	4.0
CPI (%YoY)	3.0	4.0	3.0	2.4	2.7	1.6	2.1	1.9	2.3	2.2	3.2	2.7
Unemployment Rate (% s.a.)	3.7	3.4	3.5	3.3	3.4	3.1	3.2	3.2	3.3	3.4	3.2	3.3
Policy Rate (% e.o.p)	2.50	3.25	3.25	3.25	3.25	3.00	2.75	2.75	2.75	2.50	2.75	2.75
5yr KTB (e.o.p., %)	4.08	3.46	3.70	3.42	3.42	2.87	2.90	2.90	2.90	2.85	3.05	3.05
Exports (US\$ bn)	466	555	135	140	275	133	144	277	552	278	298	576
(%YoY)	28.3	19.0	3.0	-1.7	0.5	-5.6	2.4	-1.6	-0.6	1.1	7.7	4.4
Imports (US\$ bn)	425	524	134	131	264	125	136	261	526	267	285	552
(%YoY)	31.6	23.3	7.7	-2.7	2.3	-7.1	3.6	-1.8	0.2	1.0	9.1	5.1
Trade Balance (US\$ bn)	41.2	30.8	1.3	9.5	10.9	7.9	7.8	15.7	26.6	11.2	13.0	24.2
Current Account (US\$ bn)	29.4	26.5	2.6	11.2	13.7	14.7	5.4	20.1	33.9	9.5	9.9	19.4

Source: Bank of Korea, Korea Statistics, KITA, Citi Research

Rapid economic policy change is unlikely

Given weak economic conditions in 1H and sub-par annual economic growth in 2013, we do not expect any drastic changes in macroeconomic policies or economic reform. The new government is likely to mitigate economic slowdown by boosting domestic demand, especially construction and facilities investment, by relaxing regulations on the housing market as well as corporate investment environment. Stabilization of housing prices in the Seoul metropolitan area and construction industry will be indispensable for supporting domestic demand, especially private consumption and construction investment which had taken up about 51% and 13% of real GDP respectively. A supplementary budget cannot be ruled out given sub-par economic growth in 2013. Actually, an economic advisor of Park's camp said they prepared a pledge of KRW1.1trn supplementary budget for 2013 although it was denied by other chief advisor. The government, in our view, is not likely to implement a large-scale supplementary budget in 2013 since the economy is expected to rebound in 2H13. Instead, the government is likely to frontload 2013 budget in 1H as it did in 2012 to support the economy as well as to avoid negative contribution of government spending to growth.

Active implementation of economic democratization is also likely to be delayed since it could weigh on investment sentiment of corporations, particularly Chaebols. However, we anticipate some discussions and changes in tax system to raise government revenue for social welfare spending which candidates proposed. According to an estimate by the Ministry of Strategy and Finance, the government will need extra KRW268trn during the new president's term to implement the proposed welfare and populist agenda of the three candidates -- such as free health services, free school meals, free high school education and higher salary to conscripted soldiers.

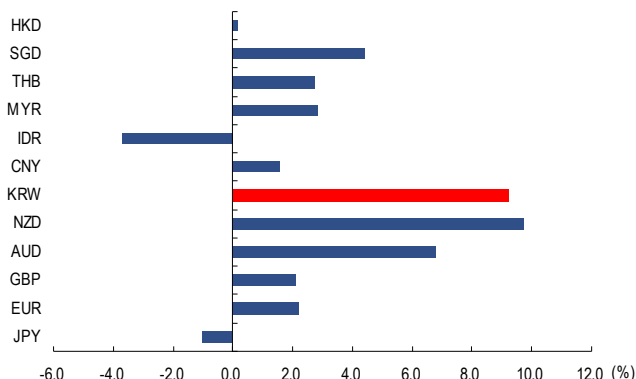
If there is a tax reform, the income tax system will most likely to be changed. Political circles are now considering widening the top income bracket -- currently at an annual salary of over KRW300m. The DUP plans to widen the bracket to over KRW150m. Furthermore, the ruling party and opposition parties all agree on introducing a transaction tax on derivatives: The Saenuri party considers 0.1bps while the DUP 1bps tax rate. The chances of changing the corporate tax system do not seem high as it could damage the competitiveness of Korea's business environment for domestic and foreign corporations.

Figure 4. Proposed Tax Reforms of the Saenuri Party and the DUP

	Current	Saenuri Party	Democratic United Party
Income tax	A tax rate of 38% is applied to the top income tax bracket of over KRW300mn	Increase taxation through overall revision	Lower the top tax bracket to over KRW150mn but maintain the tax rate of 38%
Corporate tax	A tax rate of 22% is applied to corporations in the top bracket with profits of over KRW20bn	Maintain current tax bracket/rate	Add a top bracket for over KRW50bn and tax 25%; raise the tax rate for KRW200mn~50bn to 22% from 20%
Minimum corporate tax rate	14% for large corporations with a tax base of over KRW100bn	Raise to 15% for large corporations with a tax base of over KRW100bn	Raise to 15% for large corporations with a tax base of over KRW100bn
Aggregate taxation on real estate	Taxed if the value of real estate exceeds KRW900mn	Maintain current tax rate/base	Tax if the value of real estate exceeds KRW600mn
Transfer tax on stocks	1) Taxed if shareholding of Kospi stocks is 3% or more or 2) if a shareholder holds stocks worth KRW10bn or more	1) Taxed if shareholding of Kospi stocks is 2% or more or 2) if a shareholder holds stocks worth KRW70bn or more	1) Taxed if shareholding of Kospi stocks is 2% or more or 2) if a shareholder holds stocks worth KRW50bn or more
Transaction tax on derivatives	None	0.001%	0.01%
Aggregate taxation on financial income	Over KRW40mn	Lower the tax base to KRW20mn	Lower the tax base to KRW30mn

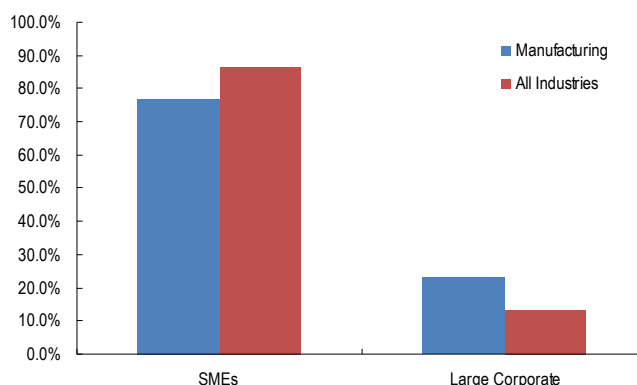
Source: Hankyoung Business Daily, Kyunghyang Daily, Citi Research

Figure 5. FX Appreciation vs. May 5th 2012



Source: Bank of Korea

Figure 6. Share of Employees of SMEs and Large Corp (2010)

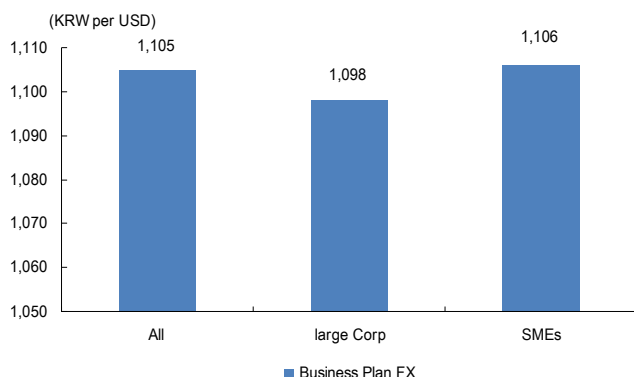


Source: Small & Medium Business Administration

On the monetary policy front, we think the BoK will cut the policy rate by 25bps in early 2013, most likely at the Feb MPC meeting after confirming headline inflation at a 1% level and anemic production activities in Jan. The policy rate will likely be unchanged to the latter part of 2013, but economic recovery and rising inflation in 2H may lead the BoK to consider normalizing the policy rate and to raise the rate by 25bps in 4Q at the earliest.

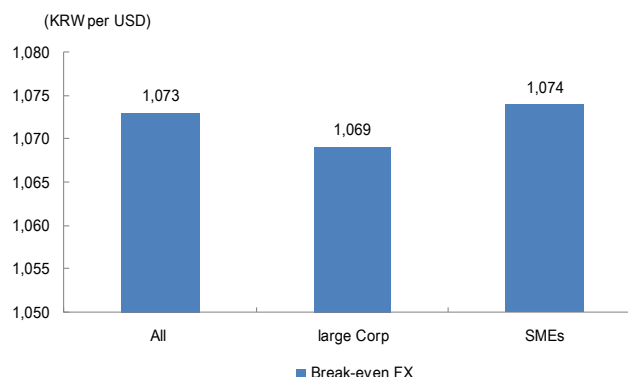
Export sectors are concerned about the sharp appreciation of KRW. USDKRW declined by 9.2% from its previous peak on 25 May and recently broke 1,090 level recording a new year-low of 1,085.4 on 7 Nov. In the mid- to long-term, we think KRW continue to gain against USD due to sound economic fundamentals - enhanced country sovereign ratings (Moody's: Aa3 & stable, Fitch: AA- & stable, S&P: A+ & stable), sound fiscal conditions (general government debt to GDP is estimated to be 34% in 2012) and current account surplus. However, on a 3-6 month horizon, KRW may become vulnerable to a possible revisit of risk aversion due to worries on the US fiscal cliff and the lingering Eurozone sovereign crisis.

Figure 7. Korean Corporations' 2012 Business Plan USDKRW



Source: Institute for International Trade, KITA, Citi Research

Figure 8. Korean Corporations' 2012 Breakeven USDKRW



Source: Institute for International Trade, KITA, Citi Research

Nevertheless, FX authorities are expected to intervene in the market to slow the appreciation of the KRW if the KRW strengthens faster than other EM currencies and if JPYKRW falls rapidly to support exports. This is because a further export slowdown, weighed down by a strong KRW, would shed jobs in the manufacturing sectors, especially SMEs which are more vulnerable to a stronger KRW than large corporations. It is worth noting that SMEs hire 76.8% of workers while large corporations employ 23.2% in the manufacturing sector.

According to a survey by the *Institute for International Trade*, Korean corporations on average set USDKRW at 1,105 for 2012 business plan: Large corporations at 1,098 and SMEs at 1,106. The break-even USDKRW is 1,073 on average with large corporations at 1,069 and SMEs at 1,074. Therefore, another 1.1% appreciation of KRW against USD from current levels would lead all corporations to operate at a deficit. Besides market intervention, macro-prudential measures could be tightened as well since the ceiling on banks' foreign exchange forward positions were introduced (Jun 2010) and tightened (May 2011) when KRW appreciated by more than 9% from its previous peak. We do not expect a new type of macro-prudential measures for now on the top of existing ceilings on forward positions as well as macro-prudential stability levy (bank levy on short-term borrowings: 20bps for less than 1-year foreign liabilities, 10bps for 1-3 year, 5bps for 3-5 year, and 2bps for more than 5-year).

Appendix A-1

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