OVERVIEW AND MACROECONOMIC ISSUES

OUTLOOK AND REFORMS FOR THE KOREAN ECONOMY IN 2006

by Kenneth Kang

After two years of sluggish growth, the Korean economy is now recovering. Economic activity began to revive in the early part of 2005 and accelerated throughout the year, reaching an annualized rate of nearly 7.5 percent in the third quarter, its fastest pace since 2003. What is encouraging is that the recovery is being led by household spending. After remaining dormant for almost two years, private consumption has now expanded for six straight quarters.

One important reason why households are able to spend again is that they have made significant progress in restructuring their delinquent debt. The government, through the personal bankruptcy system and through out-of-court workouts, has done a good job of creating a market-based framework for resolving household delinquencies. In fact, the number of credit delinquents who have had their debts rescheduled through these programs now reaches approximately 1.3 million, accounting for one-third of the peak number of credit delinquents. This has helped clear out the backlog of delinquent borrowers and provide room for many lower- and middle-income borrowers to spend again.

At the same time, exports have begun to accelerate. Starting around the middle of 2005, overseas demand for Korea's exports, particularly for high-technology products, picked up strongly. Much of this is due to the recovery in the information technology industry, which now accounts for approximately 40 percent of Korea's exports. The continued increase in U.S. orders for computers and electronic products and strong growth in China suggest that the outlook for Korea's exports will remain bright over the coming months.

On the basis of these favorable trends, we expect growth to accelerate from 3.8 percent in 2005 to 5.0 percent in 2006, driven by both domestic demand and exports. Our forecast is consistent with that of the Bank of Korea as well as many private sector forecasts.

Korea's recovery is under way, but some areas of the economy remain weak. In particular, investment remains sluggish, and it is unclear when it will revive. Part of the reason is that small and medium-size enterprises (SMEs) in Korea are facing financial difficulties and are not in a position to invest. Although large companies are earning record profits, their willingness to invest in Korea has declined, partly because of the rigidities in the labor market that keep the cost of risky investment high. Companies are also investing more overseas to take advantage of lower-cost labor and to be closer to their final markets.

In addition, there is the risk that, without a steady improvement in household incomes, the recovery in consumption may falter. Household spending currently is growing faster than disposable incomes. Without a meaningful recovery in investment that would lift up wages and employment, consumer spending may slow again. Households also still face a heavy debt burden. Although the composition of household debt has improved with restructuring, the overall level of debt remains high—near its 2002 peak—at approximately 60 percent of gross domestic product (GDP), implying that consumers remain vulnerable to an increase in interest rates or a cutoff in credit.

In these circumstances, it will be important for macroeconomic policies to continue supporting the economy. On fiscal policy, Korea's government has taken appropriate steps to stimulate the economy by cutting income and excise taxes, front-loading government spending, and implementing a supplementary budget. For 2006, we agree that the government should aim for a neutral fiscal stance and target another small deficit in the budget (excluding social security funds) in order to ensure that fiscal policy remains supportive of the recovery throughout the year. On monetary policy, we agree with the Bank of Korea's strategy to normalize interest rates as economic recovery advances but would note that the Bank of Korea has room to maneuver because inflation pressures remain subdued. At present, core inflation amounts to 1.7 percent, well below the authorities' 2.5–3.5 percent target band.

In addition to supportive macroeconomic policies, structural reforms will be crucial to help the recovery mature into rapid sustained growth. Over the longer term, structural reforms will also help make the economy more competitive and flexible to changes in the global environment. Reform is critical in three areas: restructuring the SME sector, developing the financial sector further, and enhancing the flexibility of the labor market.

SMEs and Reform

SMEs are an important part of the Korean economy. They account for approximately 85 percent of employment, 50 percent of manufacturing output, and 40 percent of exports, and they cover virtually every sector of the economy. Many SMEs have been hit hard by the economic slowdown. According to some estimates,[1] approximately one-fifth of manufacturing SMEs are incurring losses, with more than one-third unable to generate sufficient operating income to cover their interest expense. Part of the problem is cyclical because of the exposure of SMEs to the domestic market; as private spending strengthens, so should the financial position of SMEs.

The sector also faces some deep structural problems. Many SMEs are overburdened with debt and saddled with excess capacity, and they suffer from growing overseas competition. According to the Bank of Korea, the debt-equity ratio for SMEs in 2004 was 139 percent compared with 92 percent for large firms. Even more worrisome is that, since 1999, profitability of SMEs has remained at a low level while it has improved steadily for large companies.[2] Although large corporations since the financial crisis have made significant progress in restructuring and boosting profitability, SMEs have lagged far behind.

To revitalize this important sector, a two-pronged strategy is needed. First, the sector needs to undergo restructuring. Restructuring is currently hindered by the extensive system of credit guarantees that provide subsidized credit to certain firms, helping them to survive but making it harder for others to compete. Public credit guarantees in Korea amount to approximately 6 percent of GDP, more than three times larger than in Taiwan and approximately 30 times larger than in the United States.

Public credit guarantees therefore need to be scaled back gradually to allow the private sector a greater role in allocating credit. For this reason, the IMF strongly supports the government's plans to halt the growth in credit guarantees and redirect them to start-ups and new technology firms, and opposes suggestions for expanding regional guarantee funds. Without guarantees, banks will face greater incentives to lead the restructuring themselves, much as they did for the large corporations after the financial crisis. In addition, the public credit guarantee funds, with their large portfolio of SME loans, should be given more flexibility to work with the private sector in restructuring distressed SMEs; they could set up asset management companies or sell directly to the private market.

Financial Sector Reform

There is a need to improve access to financing for SMEs, particularly for start-ups. In other advanced countries, venture capital provides an important source of financing for new companies. In Korea, the venture industry needs to be strengthened further to help channel more private risk capital to start-ups and new technology firms. The government is currently the largest investor in the venture industry. To help broaden the investor base for venture capital, steps are needed to encourage long-term institutional inves-

1. Estimates include those of both the private sector and the Bank of Korea.

2. Financial Statement Analysis, Bank of Korea, various years.

tors such as pension funds and insurers to invest more in alternative assets.

At the same time, the legal framework should be upgraded to allow for more risk-based lending to SMEs. In Korea, it is difficult for small firms to borrow from banks without real estate collateral or a guarantee. To make it easier for SMEs to borrow on the basis of their future cash flow, inventory, or even technology, the civil code should be amended to allow for the registration of security interests on a wider range of assets. Other countries have adopted similar reforms with immediate positive results. For example, after Slovakia reformed its collateral law in 2002 to allow debtors to use a wider range of collateral assets such as machinery, receivables, and copyrights, more than 70 percent of all new business credit was secured by these new asset types.

Because many SMEs will inevitably fail, especially in the risky high-tech sector, there is a need to "decriminalize" bankruptcy to give failed entrepreneurs a chance to learn from their mistakes and start new businesses. This is a particular problem in the high-technology sector, where 9 out of 10 firms typically fail. Personal bankruptcy in Korea is harsh on debtors, who afterward have difficulty finding jobs or starting new businesses. More than 100 provisions in various laws discriminate against bankrupt persons. To give entrepreneurs in Korea a better chance of restarting, even after bankruptcy, employment and credit restrictions on defaulters should be eased to allow them to find new work, the range of exempted assets should be widened, and the process of discharge after completing bankruptcy plans should be accelerated. Moral hazard is always a risk when bankruptcy restrictions are eased, but this could be contained more effectively by harsh prosecution, under the criminal code instead of the commercial code, of businesspeople who loot their companies.

In addition, Korea needs to develop its financial service sector further. The financial system has advanced considerably, but it still has considerable potential in light of Korea's large savings and underdeveloped service sector. Services in 2005 accounted for approximately 55 percent of GDP, but the service sector is smaller than those of other advanced countries and has not changed much since 1990. In addition, the service sector lags behind the rest of the economy, with labor productivity in services approximately one-half that of the manufacturing sector and well below the average for members of the Organization for Economic Cooperation and Development (OECD).

Because of the role that financial services play as the main channel for financial intermediation, developing financial services further will help promote the shift to a more knowledge-based, service-oriented economy. Financial services development will also create new and better jobs, help to offset job losses in manufacturing, and raise Korea's long-term growth potential. For these reasons, the IMF supports the government's bold plans to break down barriers between financial firms as described in a new bill—popularly known as the capital markets integration bill that is to be submitted in 2006—to move to a negative-list regulatory system and to liberalize the foreign exchange market as part of its plan to transform Korea into a financial hub. These important measures will enhance competition, attract investment, and raise productivity in the service sector.

At the same time, financial supervision will need to be upgraded to keep pace with these rapid changes. To remove barriers between different financial firms, supervision will need to shift away from basing itself on institutions and move toward organizing around functions and products. This will ensure that all financial products are supervised in the same way, no matter which firms are selling them. In addition, supervisors will need to monitor and ensure that financial institutions themselves set up effective internal risk controls and Chinese walls to prevent potential conflict-of-interest abuses.

Developing and internationalizing the bond market further will also strengthen the financial system. In addition to serving as another channel for intermediation, a robust and efficient bond market can serve as a useful "third wheel" for financing to complement the banking system and equity markets, particularly in times of financial stress. Korea has the second-largest bond market in Asia—Japan is first—but it is relatively illiquid and shallow, particularly for low-rated credits, and foreign participation is small. It is surprising that foreign participation accounts for more than 40 percent of Korea's equity market but less than

1 percent of its bond market.[3] Here, further progress in restructuring the nonbanking sector, such as the securities and insurance companies; removing some tax obstacles, such as the withholding tax; and improving the quality of credit ratings and information would help to strengthen investor confidence and channel more funds through the bond market. The government's plan to improve the securities sector should also be of help.

Labor Market Reform

Finally, Korea needs a flexible labor market to create better jobs and allow companies to compete in a globalized world. Labor reform will also ensure that Korea remains an attractive place to invest for both Korean and foreign companies.

To enhance the flexibility of the labor market, we need to both reduce protection for regular workers and strengthen the social safety net for the most vulnerable. Regular workers in Korea benefit from strong employment protection. According to the World Bank, the cost of firing a regular worker in Korea is more than twice as high as the average for advanced countries.[4] Because of this high cost, Korean companies have shifted to hiring mainly nonregular workers, to the point where nonregular and self-employed workers now actually account for the bulk of employment—two-thirds of the labor force, the highest ratio in the OECD. In other words, the high protection for regular workers has led to one of the most polarized labor markets among the advanced countries. To encourage firms to hire more regular workers, employment protection for regular workers will need to be reduced.

Korea may be able to draw some useful lessons from Spain's experience with labor reform in the late 1990s. Spain also experienced a rise in nonregular workers while unemployment remained high. To promote the hiring of regular workers, Spain introduced a new type of regular contract with lower job protection. Workers already employed were able to keep their old contracts while new workers were hired under the new, more flexible, regular contract. The reform in Spain appears to have been successful in promoting regular jobs and reducing unemployment. Between 1997 and 2000, 1.5 million jobs were created in Spain, and 76 percent of these new jobs were under regular contracts. For Korea, one possible approach would be to allow for more flexible contracts for regular workers in certain industries and then expand them if proved successful.

At the same time, the social safety net will need to be strengthened. Currently, only about one in five of the unemployed receives unemployment benefits. Expanding the coverage of the social safety net, especially the employment insurance system, will not only help protect the most vulnerable workers but will also promote a more mobile labor market in which workers can move more easily to new jobs in new growth industries.

Conclusions

To sum up, the economic recovery in Korea is under way, but it is still in its early stages. For this reason, macroeconomic policies should remain supportive of the economy. In addition, further progress in structural reforms—particularly in the areas of the SME sector, the financial sector, and the labor market—is needed to ensure that this recovery matures into rapid, sustained growth. These reforms will not only help promote the recovery but also lay the foundation for a more efficient and competitive economy over the long term.

Kenneth Kang is the Resident Representative in Korea of the International Monetary Fund.

3. Korea Securities Dealers Association and the Korea Stock Exchange.

4. "Doing Business," World Bank, www.doingbusiness.org/ExploreTopics/HiringFiringWorkers/ (accessed March 2006).