



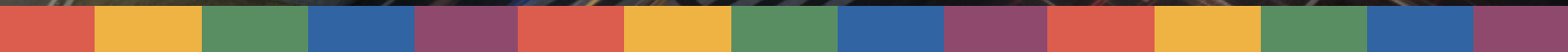
KOREA'S ECONOMY

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OVERVIEW AND MACROECONOMIC ISSUES

KOREA'S CHALLENGES AND OPPORTUNITIES IN 2011

By Chae Wook

It is undeniable that Korea successfully overcame the global financial crisis faster than any other country in the world. Last year, the *Financial Times* complimented Korea as it seemed to have pulled off a textbook recovery, and French intellectual Guy Sorman commented that the Korean economy had gone from strength to strength. Although it is certainly appreciated that there is high regard for the Korean economy, it is equally undeniable that past success does not always guarantee success in the future.

To keep the Korean economy above water in the future, the central question is how Korea will be able to find answers to challenges and turn them into opportunities. It is presently being claimed that Korea is faced with global and domestic challenges for both the short- and long- terms. As to global challenges, there will likely be lingering downside risks in the global economy, followed by deepening uncertainty in the global financial market, high commodity prices mingled with geopolitical instability in the countries of the Middle East and North Africa, sovereign vulnerabilities in the euro area, volatility of capital flows, and the impact of Japan's nuclear disaster.

Among the challenges just mentioned, it is the structural factors in the global challenges that warrant our special attention. The global economy is currently in transition, that is to say at a reflection point where the unipolar system led by the United States appears to be giving way to a multipolar system, with voices of emerging and developing economies, including China, Brazil, and India, greatly increasing. In the meantime, the global economy continues to grow, but growth has been fragile and uneven, divided between emerging markets and advanced economies. Given the high interdependence among economies in the global economic and financial system, the reflection point may actually lead to preserving deeper structural uncertainty in the global market. Moreover, as Mohamed El-Erian points out, a likely situation is the "new normal," meaning that the global economy might not return to a pre-crisis trend growth rate, and low growth may become a structural pattern.

Even more worrisome is the high possibility that cost-push inflationary pressures will frequently appear and also become structural at the global level, driven by such factors as climate change as well as cost and wage increases in emerging economies such as China. Notably, as recently analyzed by the International Monetary Fund, the volatility of capital flows has increased during the past 30 years. Despite pull and push factors and benefits to emerging economies, unless global imbalances and international monetary system reforms receive globally coordinated and effective policy measures, the increasing volatility of capital flows will continue to present a serious challenge to the Korean economy not only in the short-term but also in the long-term. In any case, Korea's high dependency on trade, as shown in the 87.9 percent dependency ratio for 2010, means greater impact from external factors in the global economy. If such structural factors become permanent, Korea has to do its utmost to deal with such challenging factors at the domestic, regional, and global levels, including the ASEAN Plus Three and the Group of 20.

When it comes to domestic challenges, immediate attention should be given to the four most pressing questions for the Korean economy: how to stabilize high consumer prices; how to strengthen economic fundamentals, including the issues of household debt and ailing local savings banks; how to enhance job-creation capability; how to promote shared growth between large companies and small- and medium-size enterprises (SMEs).

Particularly from January to May of 2011, consumer prices have remained above 4 percent year-on-year and pose a serious challenge to the Korean economy. Initially, the high prices came from supply factors related to extraordinary cold weather, foot-and-mouth disease, and commodity price hikes, but recently demand-driven inflationary pressures are also creeping in owing to inflation expectations and economic recovery. The Korean government needs to make urgent and utmost efforts, such as macro- and microeconomic measures and competition policies, to stem growing inflationary pressures.

Efforts required to tame inflation will be complicated, with household debt rising to a record 801.4 trillion *won* (\$740 billion) in the first quarter of 2011, according to the Bank of Korea in May. The ratio of household debt to disposable income was about 143 percent as of the end of 2009, which was higher than in other major countries such as the United States (125 percent) and Japan (109 percent). There are other daunting challenges looming up ahead of the Korean economy this year in the form of a pile-up in soured project finance loans and weak capital positions of savings banks. In responding to the household debt problem, the government should address the debt issue with appropriate policy choices, including microeconomic and macroeconomic measures, and monetary policy options. As for the ailing savings banks, the government should decisively overhaul the troubled sector and consider a policy option of injecting public funds to rescue the banks to calm concerns in the financial market.

Job-creation capability across the economy also needs to increase by advancing the services sector and promoting labor market flexibility. Make no mistake, Korea should not cease to liberalize and open the services sector because the manufacturing sector does not generate employment as it did in the past because of the fact that the economy is maturing.

Regarding the fourth question, it cannot be emphasized enough that shared growth between large companies and SMEs holds the key to spreading the fruit of the economic recovery across the board and helping to sustain the Korean economy for the long term.

In 2010, the Korean economy registered 6.2 percent annual growth. In the first quarter of 2011, it achieved growth in exports of 29.9 percent. By such achievements in the aftermath of the crisis, Korea appears to have established a foothold for a big leap in the near future. Yet to make that leap Korea needs to come up with effective and socially acceptable answers to structural challenges such as low birth rates and an aging population, the strengthening of fiscal consolidation, and the raising of a new growth engine.

From a more structural perspective, Korea stands at a critical juncture: whether it will enter the ranks of advanced economies in earnest. First, as the Korean economy is becoming mature, it appears to be facing a limitation in growth with factors of production expanded. In particular, to further prepare for the challenge of low birth rates and an aging population, the *modus operandi* should be to promote economic growth driven by creativity and innovation, not by increasing factor inputs. Old growth paradigms may no longer be viable as developing and emerging economies are catching up with Korea rapidly.

Second, operating on a new growth paradigm, Korea now is in a situation to create a new system for rational coordination of conflicting economic interests, including between regions and between different generations as the economy moves toward advanced stages. One very important area with respect to these conflicting interests is how to maintain fiscal soundness over the medium-term and long-term. Korea recently experienced heated political debates on welfare issues such as free school lunches and half tuition, and the debate should provide a precious moment for Korea to ask itself whether it is ready to pass its burden to a future generation.

Last but not least, Korea should be poised to make significant breakthroughs to develop and promote a future growth engine. Major industries in Korea today are not likely to be the major industries of tomorrow. While doing its best to maintain the competitiveness of its manufacturing sector, Korea should prepare to launch itself into the future with new growth engines such as the green industries and the services sector.

There is a saying that the future belongs to those who prepare for it today. Korea's track record from the 1997 Asian crisis and 2008 global financial crisis proves that Korea is decisive and swift in efforts to turn challenges into opportunities. On the international front, Korea should continue to pull everyone together, as in the G-20 and in South-South cooperation, to address global challenges. On the domestic front, Korea may find an answer to those challenges by thinking outside the box. A solution may require Korea to go beyond its own knowledge and experiences. Just as it has faced all challenges decisively and swiftly, there is no doubt that Korea will not shy away from taking on seemingly difficult challenges, which, after all, are actually opportunities in disguise.

Chae Wook is the President of the Korea Institute for International Economic Policy.

Selected Commentary

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Korea's Challenges and Opportunities in 2011

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A Reflection on the Seoul Summit

Paul Volcker, Former Chairman of the Federal Reserve

The G-20: Achievements and Challenges

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Korean Green Growth in a Global Context

Han Seung-soo, Global Green Growth Institute

Korea's Green Energy Policies and Prospects

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Achievements in Seoul and Korea's Role in the G-20

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Korea Economic Institute

1800 K Street, N.W.

Suite 1010

Washington D.C., 20006