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OVERVIEW AND MACROECONOMIC ISSUES

KOREA'S ECONOMIC ACHIEVEMENTS AND PROSPECTS

By Pyo Hak-kil

Per Capita Income Greater Than $20,000

According to a preliminary estimate by the Bank of Korea on 4 January 2008, Korea's per capita gross domestic product (GDP) and per capita gross national income (GNI), which adjusts GDP for changes in terms of trade, exceeded $20,000 by the end of 2007. This was achieved mainly through the rapid appreciation of the won from a rate of 1,011 won per dollar as of end of 2005 to 900.7 won per dollar at the end of October 2007, as the growth rate of real GDP in 2007 was estimated to be less than 5 percent. Korea appears to be the only formerly colonized nation that has thus far surpassed the per capita income level of $20,000.

Korea's per capita GNI passed the $10,000 mark in 1995, when it reached $11,432, but plummeted to $7,355 in 1998 after the financial crisis. It started to recover in 2000, when it reached $10,841. It was during the Roh Moo-hyun government that per capita GNI increased from $11,497 (2002) to $20,000. Thus, the Roh government must be credited with this remarkable achievement. In addition to growth in per capita income, there were other economic achievements. They include price stability and a surplus in the trade balance, which are often main macroeconomic policy targets for any open economy. The Roh government should also be credited for initiating free trade agreements with Japan, the United States, and the European Union.

In response to President-elect Lee Myung-bak's claim that Korea must recover from economic stagnation, President Roh argued that there was nothing wrong with the current state of the Korean economy and, therefore, that there is nothing to recover from. Nevertheless, the issue of economic recovery or revitalization was a dominant one throughout the presidential campaign in 2007, and the major opposition party candidate, Lee Myung-bak, early in his campaign seized on this public perception and managed to win election despite a great deal of negative campaigning and personal scandal.

Immiserizing Growth and Polarization

The question arises as to why average Koreans have been distressed and were not happy with the economic performance by the Roh government even though the macroeconomic fundamentals have been seemingly sound, with per capita GNI increasing at an average annual rate of 2.7 percent, a mild inflation rate of 2.9 percent in terms of the consumer price index, and a continuing current account surplus during the past five years.

First, the average annual growth of the economy (4.4 percent for real GDP and 2.7 percent for real GNI) was below the level of the economy's potential growth. Economists at Korea Development Institute estimated in 2002 that Korea's potential GDP growth rate during the period 2003–07 would be around 5.5 percent, and a study by the Bank of Korea in 2005 estimated the country's growth at the 5.4–6.0 percent level for the period 2000–10. At the time of the International Monetary Fund consultation in November 2006, I estimated that the country's growth would be at the 6.0–6.5 percent level. Thus, the Korean economy did not live up to its potential even though there are differing estimates of the extent of the GDP gap. In addition, the average growth rate of real GNI was much less than that of real GDP because of the continued worsening of the terms of trade index, which declined from 100 in the base year of 2000 to 68.6 by the end of September 2007. In other words, the general feeling of the Korean public is that the economy has become less vibrant because of the lack of growth in real income.

Second, the economy's growth during the Roh administration was not driven by investment but by a government-initiated construction boom and extraordinary export growth (17.9 percent average growth on a customs clearance basis) in a few sectors including automobiles, semiconductors, ship building, communications equipment, and iron and steel products. During the Roh administration, the average growth rate of real investment was only 3.4 percent, which is well below the average growth rate of real GDP (4.8 percent).

During previous governments in Korea before the financial crisis, the average growth rates of real investment had always been well above and usually double the average growth rate of real GDP. For example, the average growth rate of real GDP during the precrisis period of 1985–97 was 8.1 percent, and it was mainly supported by higher growth rates of real investment on machinery and equipment, which averaged 11.8 percent. In short, the quality and sources of growth were not sound enough to warrant the public perception of improvement in economic well-being. I would define this phenomenon as a kind of "immiserizing growth syndrome," an expression that has been used by international trade theorists to define a pattern of growth that lacks significant real income growth as a consequence of worsening terms of trade or capital flight by foreign investors.

Third, while economic fundamentals remain seemingly sound, average Koreans have been deeply distressed by worsening income and wealth distribution, mainly caused by the failure of the Roh government's real estate policy. The failure began with the fulfillment of one of the government's populist campaign agenda items, which was the relocation of important administrative functions from Seoul to Chungwon in Choongnam Province. The relocation of the headquarters of more than 100 public corporations and enterprises from Seoul to remote localities under the slogan of a "balanced national land development plan" was another example that lacked economic feasibility and efficiency for these public entities. Some of these projects' groundbreaking ceremonies were hurriedly launched before the Lee government was inaugurated so that there could be no backtracking in the plans.

The unwarranted development and relocation projects have been core factors behind the hyperinflation in real estate prices, particularly in the Seoul metropolitan area. With October 2003 as the base index of 100, sales prices of Seoul apartments rose to the level of 140 by the end of September 2007. Real estate prices increased at an annual rate of 24.1 percent in 2006 alone. During the same period, sales prices of housing nationwide went up by 18 percent, and the cost to lease a Seoul apartment went up by 15 percent.

There are two main factors behind this unprecedented housing price hike. One is the speculative reinvestment by those who obtained windfall land compensation money, which was estimated to be more than 64 trillion *won.* The other is the rent-seeking money for redevelopment projects that often have been subject to uneven deregulation policies by the city government. In fact, the failure of the real estate stabilization policy by the Roh government ruined the government's legitimacy by polarizing both income and wealth distribution, and it ultimately led to the powerlessness of the government toward the end of the Roh presidency. In some sense, the ultimate responsibility of the new Lee government is rectifying and consolidating the unfinished agendas and rampant development projects of the Roh government.

Unfinished Agenda of the Roh Government

The year 2007 was the last full year in office for President Roh, who was inaugurated in February 2003 after an unanticipated upset victory over Lee Hoi-chang. The presidential election on 19 December 2007 elected candidate Lee Myung-bak by a large margin over the ruling party candidate, Chung Dong-young. President-elect Lee served as mayor of Seoul before he launched his presidential campaign. Because of his leadership in the Chunggechun project (a revitalization project of a downtown water channel) and Seoul's traffic improvement plans, he led in the public polls among presidential candidates throughout 2007. His slogan of "economic revival" seems to have persuaded the voters who were much distressed by stagnant recovery and skyrocketing housing prices and resulting high property taxes.

In retrospect, it can be seen that the Roh government inherited the Kim Dae-jung government (1998–2002) in many respects. It adopted Kim's engagement or conciliatory policy toward North Korea and an economic policy in favor of better income distribution rather than a growth-oriented policy. Roh and Kim shared a reform-oriented national agenda of trying to undo everything and topple the power of the so-called establishment. Even though the political opposition called the tenure of the two regimes “left-wing governments” and Korea’s “lost decade,” it seems premature to evaluate their achievements and failure.

One positive aspect of political economy developed during the past decade or so was a more transparent system of political contributions and election management. The two special prosecutors who were appointed to investigate the so-called BBK scandal and Samsung scandal symbolize the election year’s negative campaigns on the one hand, but on the other they also reflect strong public sentiment for higher moral standards for political and business leaders in Korea. The consequences of the two probes will greatly influence the general election for the National Assembly in April 2008 and the political stability of the new Lee government.

Pending Korea-U.S. Free Trade Agreement

On 30 June 2007, the Korea-U.S. Free Trade Agreement (KORUS FTA) was signed after eight rounds of negotiations lasting 10 months. The agreement consists of 24 chapters, with a significant reduction in tariffs on industrial and agricultural products. It also includes the provisions specified in a bipartisan agreement on trade reached between the U.S. administration and the U.S. Congress on 10 May 2007, which addresses internationally recognized standards and principles on labor and environmental protection. The Korean economy is now the 11th largest in the world, and Korea is the seventh-largest trading partner of the United States, with an annual GDP of nearly $1 trillion dollars, and a two-way U.S.-Korea trade volume of $78 billion in 2006. The U.S. International Trade Commission has estimated that the overall U.S. GDP is expected to increase as much as $11.9 billion because of the KORUS FTA. The KORUS FTA will be the largest and commercially most significant FTA for the United States in more than a decade and the first one for the United States in Northeast Asia.

Ratification of the agreement is pending because of political reasons on the both sides. On the Korean side, ratification was proposed by the Roh administration in September 2007 but was stalled owing to Korea’s presidential election on 19 December 2007; it continues to be uncertain because of Korea’s general election for the National Assembly coming up in April 2008. On the U.S. side, there will be a presidential election in November 2008; therefore, if the Congress is to ratify the agreement in 2008, the Bush administration needs to submit it to Congress at the latest by March 2008 because of the congressional rule requiring submission of bills 90 days before congressional decision. Because of the election in the United States in November 2008, after July 2008 the U.S. Congress will be in session only for limited periods.

At the present time, the two major candidates of the Democratic Party, Senator Barack Obama and Senator Hillary Clinton, are opposing the ratification of the U.S.-Korea FTA. Because of the uncertainty, the Bush administration has not been able to submit the bill for ratification. With this tight schedule in mind, Korea’s newly inaugurated Lee administration will push forward the ratification before or after Korea’s general election by opening the country to imports of the U.S. beef, further following less strict import criteria set by the World Organization for Animal Health (OIE). The issue of importing U.S. beef has been identified as a major congressional ratification bottleneck.

Political Economy of Deregulation and the Grand Canal Project

Newly elected President Lee is expected to push forward a policy package for economic revitalization and the Grand Canal Project promised during his campaign. A policy package for economic recovery and restoring competitiveness includes deregulation of investment constraints imposed on large conglomerates and the elimination of the separation between industrial capital and financial capital. So far, the Korean government has been relying on two policy instruments to limit the economic power of the country’s major conglomerates, the *chaebol*. One is the Fair Trade Act, which has served not only an antitrust function but also as an investment-control scheme for major conglomerates in excess of a stipulated level of assets. The other is the prohibition on major industrial capital owning banking capital. The new government will try to abolish both types of investment-related regulations to promote both competition and efficiency. In the past, it has been argued that these two policy instruments have put domestic conglomerates at a disadvantage compared with foreign capital, as witnessed in the Lone Star investment case, which is still in dispute.

A set of pro-business policies will certainly help revitalize domestic demand for investment, but there have been reasons for maintaining such restrictive policies. Critics have argued that it is premature to remove the restrictive policies because corporate transparency in ownership and management in Korea is still below global standards, and the practice of cross-ownership and cross-investment among both listed subsidiaries and unlisted firms has not been reduced since the financial crisis of 1997–98. Critics also argue that major conglomerates have already penetrated nonbank financial businesses, including merchant banking, lease and credit card businesses, and insurance and banking with limited or disguised ownership, and, therefore, that the full opening of all banks to ownership by major conglomerates is too risky given the public and prudent nature of the banking business.

The new Lee government wants to privatize public banks such as Korea Development Bank and Woori Bank, which has received injections of public funds since 1998. In this context, it is more likely that such deregulation is pursued step by step so that banks can be owned not by a single conglomerate but by the syndicated capital of multiple conglomerates. Another dimension of this issue is the Lee government's labor relations. The Korea Confederation of Trade Unions (Minju Nochong) did not endorse the Lee candidacy although the Federation of Korean Trade Unions (Hankuk Nochong) did. The former has already announced that it cannot endorse the new government's pro-business policies and may rely on more hard-line policies, including nationwide strikes. The traditional split between the two labor organizations will make deregulation and privatization measures more complicated. In fact, the so-called public sector reform plans under both the Kim and the Roh governments failed owing to labor disputes and agency problems in most of the public enterprises and quasi-public banks and institutions.

The Grand Canal Project, a symbolic cornerstone project of the president-elect during his campaign, is likely to bring more controversy than any other policy measure. The project envisions building a long canal system along the central mountain corridors, linking the Han River in Seoul to the Nakdong River in the Taegu area as well as to the southeastern Honam area. Proponents of the proposed project argue that the canal will aid river transport and ease the burden on highways and railroads; it will also improve water management and tourism. Opponents question the economic feasibility of the project and voice environmental concerns. If the project is to be completed within the term of the Lee presidency, it will have to be launched during 2008. To avoid debate on its economic feasibility, the new government is expected to propose private participation in the project in the form of either build-to-transfer or build-to-manage. Critics argue, however, that no private investor will participate unless it either is subsidized or receives guarantees by the government or is given unfair privileges of land development along the canal. This will become a hot topic during the elections for the National Assembly in April 2008.

Target of 6 Percent Growth

According to figures released in the first week of January 2008 by the U.S. Department of Commerce, import prices in 2007 rose at their fastest rate (10.9 percent) in the 25 years since recording these data began in 1982, underlining the threat of stagflation as the United States enters a period of slower economic growth. The price of petroleum imports rose by 50 percent during 2007 while nonpetroleum import prices rose by 3 percent. Meanwhile, the subprime mortgage crisis and housing slump are likely to have reduced U.S. economic growth during the last quarter in 2007 to 2 percent, down from 4.9 percent in the third quarter of the year. On 10 January 2008, Ben Bernanke, Chairman of the Federal Reserve, hinting at further rate cuts, said the U.S. central bank planned to act aggressively to offset the risks to growth. President George W. Bush is reported to be proposing tax relief of $145 billion in the form of a one-time tax rebate of up to $800 for individuals and $1,600 for married couples because such a fiscal stimulus hands money directly to consumers so that there will be less waste of time and money. Democratic presidential candidates are already pushing for higher benefits and public spending. But there will be limits to expansionary policies because the banks are worried about liquidity and default risks, while consumers are faced with higher inflation and reduced values of their property.

In Korea, the new Lee administration will be attempting to achieve 6 percent growth of real GDP in 2008, which is lower than the average growth target of 7 percent for five years that Lee promised during his campaign. But 7 percent is higher than the consensus rate (4.5–5.0 percent) predicted by most private research institutes. If a U.S. recession materializes during the first half of 2008, Korea's 6 percent growth target will be difficult to achieve because both domestic consumption and exports, which have been supporting GDP growth through their average growth rates of 2.6 percent and 17.9 percent, respectively, during the period 2003–07 are likely to slow down because of inflation and the greatly appreciated won. Even if high growth is achieved by fiscal expansion, tax reduction, and decreased regulation of conglomerates, it may take place amid higher inflation and a more stagnant economy.

The real estate policy of Korea's new government already seems to be challenged significantly by the recent movement of real estate prices. The owners of high-priced housing and redevelopment projects are hoarding their properties to avoid the current high property taxes and capital gains taxes in anticipation of tax reductions by the new government in the coming year. This means the supply of housing will be constrained, and there could be another round of real estate speculation.

Finally, the dismal prospect for resolution of the North Korean nuclear issue caused by North Korea's failure to conform with the stipulated deadline of 31 December 2007 adds another negative prospect for 2008. Since the 2007 presidential election, North Korea has been silent on the South-North relations. The presidential election process in the United States, which has just begun, might favor a hard-line policy toward North Korea.

The uncertain prospects for South-North relations and the six-party talks may cloud the new government's effort to revitalize the Korean economy. Therefore, the new Lee administration may have to face much harder economic realities than expected because institutional deregulation cannot be accomplished overnight; also, changes also often come with other distortions. The aspects of political economy surrounding the proposed Grand Canal Project and South-North relations are quite uncertain.

Prospects for Sustainable Growth and Policy Implications

According to my recent estimation using the Korea Industrial Productivity (KIP) database and the EU KLEMS Project database (March 2007 version),[1] the international comparison of long-run growth and its decomposition lead us to an optimistic conclusion. The study shows that, during the period 1981–95, the market economy portion of real GDP in the United States, Japan, and Korea increased at an average annual rate of 3.0 percent, 3.6 percent, and 9.4 percent, respectively. During the period 1996–04, which includes Japan's "lost decade," Korea's financial crisis, and the U.S.-initiated boom in information technology, the average annual growth rates of real GDP were 3.7 percent, 0.7 percent, and 4.9 percent, respectively.

The growth decomposition reveals a more interesting fact: All three of these economies suffered from aging and a reduction of working hours. The growth rates of labor input decreased in the United States from 1.2 percent to 0.7 percent, in Japan from 0.5 percent to -0.4 percent, and in Korea from 1.9 percent to 0.7 percent during the corresponding two subperiods. While the growth rates of capital input declined in Japan from 1.9 percent to 0.7 percent and in Korea from 5.5 percent to 3.3 percent, the growth rate of U.S. capital input increased from 1.1 percent to 1.4 percent.

The measure of overall economic efficiency, which is defined as total factor productivity (TFP) and measured as a residual after deducting the contribution of labor and capital input from GDP growth, reveals the same pattern as that of capital input. While the growth rates of TFP declined in Japan and Korea from 1.2 percent to 0.4 percent and from 2.0 percent to 0.9 percent, respectively, the growth rate in the United States increased from 0.7 percent to 1.6 percent. During the period 1996–2004, the relative contribution of TFP to GDP growth in the United States was more than 50

1. Pyo Hak-kil, Hyunbae Chun, and Keunhee Rhee, *Total Factor Productivity by 72 Industries in Korea and International Comparison* (Seoul: Bank of Korea, February 2008).

percent while its relative contribution in Korea was less than 20 percent. In Japan, the relative contribution of TFP was more than 50 percent, but it was meaningless because Japan's GDP growth rate (0.7 percent) was very low during the period.

As outlined above, even though the prospects for Korea's economic recovery in 2008 are uncertain owing to the domestic political economy and the threat of stagflation in the world economy caused by subprime mortgage problems and high oil prices, the medium-term growth prospect of the Korean economy seems quite sound and stable if the new government introduces a set of policies that are designed for restoring growth momentum and competitive potential rather than short-sighted populist policies. Such a set of growth policies may invite criticism from different political interest groups, and the public may become impatient about the speed of recovery, but clinging to the populist agenda is likely to ruin the ultimate policy goal of the new government, which is restoring growth momentum and national competitiveness.

The new government should redesign its policy package and its priorities independent of campaign promises and embedded political interests. The advantage of a single-term presidency is its limited time horizon, and, therefore, it is necessary to persuade the public to help restore the national agenda for a resumption of sustainable growth and national competitiveness rather than seek windfall gains and short-run incentives. In this respect, the policy directives of the new Lee government must restore investment potential and upgrade the overall efficiency of the economy through consistent deregulation, enhanced investments in research and development, and institutional reforms in education and social welfare rather than insist on short-sighted populist election agendas such as unwarranted development projects. Learning from the failures of the Roh regime will be the best lesson for the new administration.

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