OVERVIEW AND MACROECONOMIC ISSUES

KOREA'S ECONOMIC PROSPECTS AND CHALLENGES[1]

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Abstract

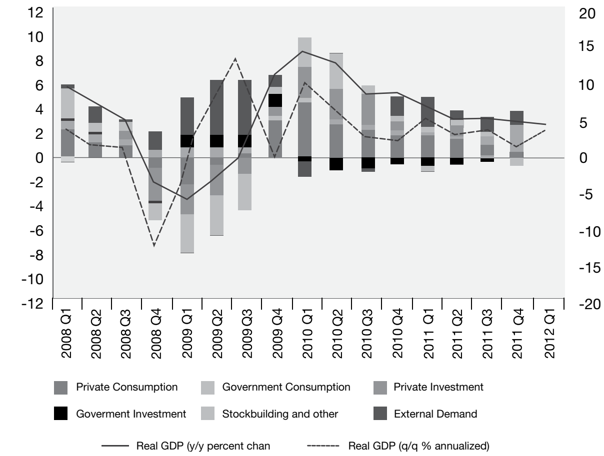
Following a strong rebound in 2010, growth in Korea slowed down in 2011 to 3½ percent due to domestic factors and weakness in the global economy. While recent data suggest that the economy will bottom out in mid-year and strengthen during the course of 2012, on-going weakness in the global economy represent downside risks to this scenario. Additionally, even if the global economy were to deteriorate further, Korea still has ample fiscal space to respond with a fiscal stimulus package similar to what was done in 2008-09, if necessary. At the same time, headline inflation has decelerated in large part due to government measures and favorable base effects and the external vulnerability of the Korean financial system has significantly diminished since 2010. However, households' high indebtedness has been flagged as another important vulnerability for the financial system, with the household debt-to-disposable income ratio now at 135 percent and Korea is still one of the economies in Asia most exposed to foreign bank funding risks. One of the key medium-term policy challenges is to respond to the public's call for more social spending and inclusive growth. Given the medium-term fiscal consolidation plan, the government should carefully calibrate the scope for raising social spending.

Despite Global Headwinds, Korea's Growth Outlook Remains Positive

Despite some uncertainties in the outlook for global activity, economic growth in Asia seems to be maintaining momentum. In the last quarter of 2011, activity slowed markedly across the region, but in the first months of 2012, leading indicators of activity have strengthened. Meanwhile inflation has picked up in some countries, and capital flows to Emerging Asia have rebounded. As reported in the IMF's latest Regional Economic Outlook for Asia and the Pacific (REO) (http://www.imf.org), Asia is projected to grow at 6 percent in 2012 before rising to about 6½ percent in 2013. Korea's economy is projected to follow a similar trend. Growth momentum was accelerating in 2010 and into 2011 before a deterioration in the global economy led to a slowing of growth in the second half of the year. This somewhat slower growth is continuing in the first half of 2012 but momentum is expected to be restored in the second half of the year.

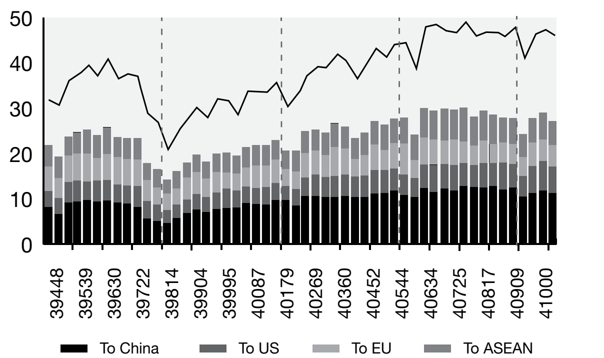
The remainder of this article is organized as follows. The first section focuses on economic developments in 2011 and the outlook for 2012-13. The second section discusses Korea's progress in strengthening financial resilience in the face of global volatility. The third section elaborates on the medium-term challenge of increasing social spending and creating a more inclusive growth model.

Figure 1 Contributions to GDP Growth (as a %)



Source: CEIC Data Company Ltd.; and IMF Staff Calculation

Figure 2 Exports Value by Destination (in U.S. billions)



Sources: CEIC Data Company Ltd.; and IMF Staff Calculation.
Malaysia, Philippines, Thailand, Indonesia, Singapore, and Vietnam included for ASEAN.

Balancing Growth and Inflation

Following a strong rebound in 2010, growth slowed down in 2011 to 3½ percent because of a housing supply overhang, sluggish investment, the withdrawal of fiscal stimulus, the impact of high household indebtedness on private consumption, and weakness in the global economy. Growth surprised on the upside in the first quarter of 2012, with broad-based recovery in domestic demand, but may be slowing again in the second quarter in line with weakness in the global economy. Recent data, and our projections, suggest that the economy will bottom out and strengthen during the course of 2012. Korea's diversified export base will help cushion the impact of weakness in the advanced economies. The recently ratified free-trade agreement with the United States, and Korean exporters' expansion into the growing markets of developing countries, will also help. On the domestic demand side, staff expects investment to recover, and private consumption to return to its trend growth. Accordingly, we have forecast Korea's economy to grow at 3 to 3¼ percent in 2012 before rising to about 4 percent in 2013.

Elevated inflation was a key policy challenge confronting the Bank of Korea in 2011. Headline inflation remained stubbornly high and above the Bank of Korea's (BOK) 2-4 percent target band for most of 2011, despite weak activity in the last quarter of the year. Food price inflation peaked in the middle of the year and fell sharply in the second half, but this decline was not able to offset the inflationary pressures from increasing prices of housing and transportation. A sharp exchange rate depreciation in the third quarter also contributed to elevated inflation.

More recently, headline inflation has decelerated in large part due to government measures and favorable base effects. Headline inflation has come off to 2¼ percent in June 2012, below the midpoint of the target band. However, this reflects temporary measures as the decline was largely driven by government subsidies on childcare and free school meals, as well as base effects. Around one-half of a percentage point of the decline in headline inflation can be attributed to these government measures. Food price disinflation, which contributed to declining inflation earlier, appears to have run its course. Core inflation also fell to 2 percent in March from 2½ percent during the previous month.

Despite the recent moderation in inflation, inflation pressures are projected to resurface in 2013. We expect inflation to be about 3 percent for 2012, slightly above the mid-point of the BOK's target band. Downward movements in headline inflation are unlikely to continue as there are no plans to implement additional administrative measures. Despite the drop in headline inflation, certain components of the Consumer Price Index basket with large weights (such as housing, transport and clothing) continue to see strong increases. Food price-led declines have troughed, implying that food prices will not contribute to a further drop in headline inflation. And despite declining headline inflation, inflation expectations remain close to 4 percent. Furthermore, there are upside risks to the inflation outlook from the need for utility price hikes going forward.

Guarding against risks to growth, while shepherding a soft landing for inflation, requires a delicate mix of policies. The current macro policy mix combines an accommodative monetary policy and a broadly neutral fiscal stance. On the fiscal policy side, the objective is to support growth—including by fully allowing automatic stabilizers to work—while not derailing medium-term efforts to restore fiscal space. The government appropriately chose to front-load 60 percent of its 2012 budget in the first half of the year given the weaknesses in the global economy. Even if the global economy were to deteriorate further, Korea still has ample fiscal space to respond with a fiscal package similar to what was done in 2008-09, if necessary. On the monetary policy side, we continue to believe it will be necessary to resume a normalization of monetary policy through interest rate increases in 2013 based on a forecast closing of the output gap (the difference between actual and potential economic output), continued risks to inflation, and to further build policy space and enhance credibility.

Safeguarding Financial Stability

Korean banks' large external short-term borrowing and their exposure to foreign exchange volatility were key vulnerabilities prior to the Global Financial Crisis (GFC). Korea's exposure to European banks on the funding side is among the highest in Asia. However, since 2008, the external vulnerability of the Korean financial system has significantly diminished, reflecting higher reserves to short-term debt cover, lower reliance on wholesale funding, reduced foreign exchange liquidity mismatches, diversification of the foreign investor base in domestic bond and onshore dollar funding markets, and the adoption of a series of macroprudential measures since 2010. These measures include: a 100 percent cap on the *won*-denominated loan-to-deposit ratio; ceilings on banks' foreign exchange derivative positions; tighter foreign exchange liquidity standards complemented by more frequent stress tests; stricter regulation of domestic foreign currency lending; a macroprudential levy on the foreign currency-denominated non-core bank liabilities; and a withholding tax on foreign investors' interest income on government bonds.

The initial set of post-GFC measures targeted banks' active use of short-term foreign-exchange liquidity and the resulting increase in the maturity and currency mismatches on banks' balance sheets. The underlying concerns reflected banks' strong reliance on non-core liabilities. The introduced measures included: (i) an increase in the ratio of long-term foreign exchange funding to foreign exchange lending, enacted in November 2009 and set at 90 percent; (ii) a cap on the value of forward foreign exchange contracts between banks and domestic exporters, introduced in November 2009 and set at 125 percent of export revenues; and (iii) a maximum loan-deposit ratio of 100 percent for domestic banks, introduced as a guideline in December 2009, and expected to be implemented by end-2013. During this initial phase, the Korean authorities also introduced more stringent capital requirements on bank holding companies to ensure sufficient absorption of potential losses.

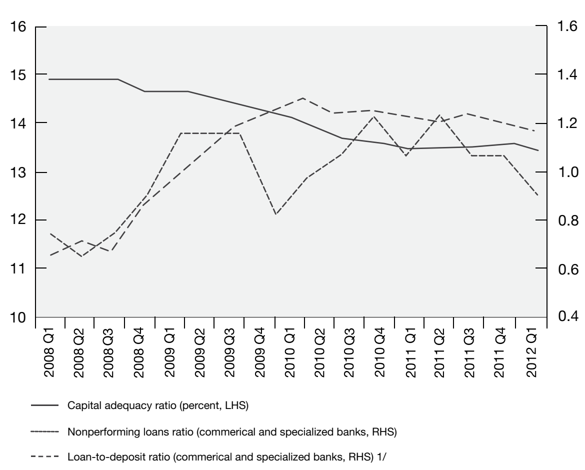
In a second phase, in 2010, the authorities expanded the set of measures to contain banks' short-term foreign currency debt. In October 2010, they established a ceiling on banks' foreign currency derivative positions, including those from foreign exchange forward contracts bought from domestic exporters and asset management companies for currency hedging. The derivatives ceiling was set relative to banks' capital, with domestic banks facing a ceiling of 50 percent of capital and foreign branches 250 percent of capital. The ceilings were subsequently tightened even further in July 2011 to 40 percent for domestic banks and 200 percent for foreign banks. The ratio of forward contracts to underlying export revenues was also reduced to 100 percent. Measures on foreign currency borrowing were bolstered as well. New measures on banks' foreign currency loans were meant to prevent excessive foreign currency leverage in the corporate sector. Taken together, this set of macroprudential measures was meant to reduce the channeling of bank funding to foreign currency forward positions in the domestic market and guard against an abrupt withdrawal of capital. The Korean authorities also re-introduced a withholding tax on foreign purchases of treasury and monetary stabilization bonds in January 2011. In essence, this aligned the tax with the equivalent for resident bond purchases. The only explicit exemption was provided for official investors.

Households' high indebtedness has been flagged as another important vulnerability for the financial system, with the household debt-to-disposable income ratio now at 135 percent, similar to levels in advanced economies such as the U.K. and the U.S. Household exposure to interest rate and rollover risks, therefore, present vulnerabilities despite relatively stable house prices, favorable net asset positions, and low loan-to-value ratios. However, one unique feature of Korea's housing market could lead to inflated levels of household debt. The Jeonse system requires tenants to place a refundable deposit of 50-70 percent of the price of a rented house to landlords at no interest. This arrangement pushes up both household liabilities and assets but has no impact on the net-asset position which remains relatively strong.

The banking system's exposure to foreign exchange liquidity risks has also decreased sharply. This decrease reflects both strengthened regulation of foreign currency liquidity risks and reduction in banks' external short-term borrowing, which had been partly driven by the demand for hedging by Korean shipbuilders and other exporters. Moreover, the foreign investor base in domestic bonds (who also supply dollar liquidity in the onshore swap markets) has broadened to include official investors (notably some regional central banks). The diversification has reduced the risk of market herding behavior, given the low correlation between liquidity risks faced by large global banks (which still dominate the base) and those faced by the regional central banks. Because of these changes, Korea's exchange rate volatility, which tended to surge during the past crises, has become less sensitive to global risk factors: the sensitivity of the exchange rate volatility to changes in indicators of global volatility is estimated to have declined by more than a half since the GFC.

Even though the banking system vulnerabilities have diminished since 2008, it is important to remain vigilant. The negative impact of euro-area bank deleveraging has so far been limited. However, Korea is still one of the economies in Asia most exposed to foreign bank funding risks. In the aftermath of the 2008 crisis, massive capital outflows caused the claims by the Bank of International Settlements reporting banks on Korea to fall by more than 70 billion dollars. As banks were unable to rollover their short-term debt, the

Figure 3 Capital Adequacy, Nonperforming Loans, and Loan-to-Deposit Ratio



Source: CEIC Data Company Ltd.; FSS; and IMF Staff Calculation
1/ Specialized banks are not subject to loan-to-loan deposit limit.

Bank of Korea had to intervene with about 65 billion dollars of reserves to cushion the liquidity squeeze on the economy. Even so, the *won* exchange rate fell by 32 percent, from the pre-crisis peak to trough, while stock prices declined by 35 percent. The financial stress also affected the real economy through slower credit growth. Looking ahead, the possibility of rollover difficulties resulting from an intensification of the euro-zone crisis cannot be ruled out.

In the third quarter of 2011, there was a sudden surge in capital outflows (including from the banking sector). This led to some funding pressures causing depreciation of the exchange rate by 10 percent. Since the beginning of 2012, capital inflows have resumed led by both equity and fixed income flows, although banking capital flows remain subdued. Going forward, the downside risks from intensification of the euro-zone crisis appear to be balanced by the high upside risk for capital flows, particularly portfolio flows, if risk appetite recovers. Given the improved financial resilience and macroprudential policies in place, Korea is well positioned to manage any future bouts of capital flow volatility. Flexibility in macroeconomic policy will also remain an important part of dealing with economic shocks as the extensive macroprudential policies put in place are an important complement but cannot be a substitute for appropriate macroeconomic policy settings.

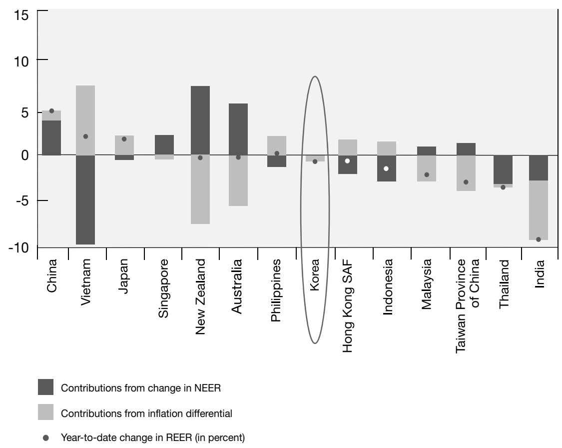
Social Spending and Inclusive Growth

One of the key medium-term policy challenges is to respond, in a careful yet effective way, to the public's call for more social spending and inclusive growth—a particular challenge in this dual election year. Given the medium-term consolidation plan, the government should carefully calibrate the scope for raising social spending; making sure that the bulk of the increase is matched by either additional revenues or cuts in other expenditures. To support this, more work also needs to be done in integrating long-term issues into the fiscal framework. Labor market reforms and raising the productivity of the service sector are key areas of reform to strengthen growth potential.

While Korea has one of the youngest populations in the Organization for Economic Cooperation and Development (OECD), it is projected to shift to among the oldest by mid century, given its low fertility rate and rapid gains in longevity. Although pressures will not show in the near term, given the current age profile of the population, age-related spending will begin to appear in the medium term and accelerate from 2020 with the rapid aging of the population.[2] Meanwhile, during the most recent decade, income inequality has rapidly risen to the OECD average level.

Korea is among five OECD countries singled out for a high degree of inequality originating from the labor market. The

Figure 4 Asia: Contributions to Changes Since Dec 2010 in REER (as a %, Apr 2012)

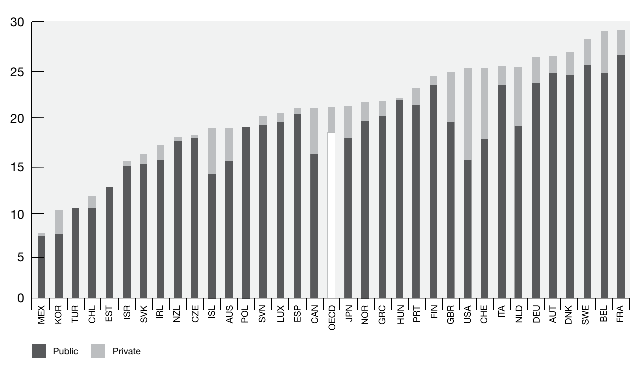


Source: APDCORE; and IMF Staff Calculation.

degree and cost of employment protection for regular workers has gradually risen to a point where companies have begun to shift most new jobs to nonregular workers. As a result, the share of nonregular workers is significantly higher than the OECD average, and they are paid about 40 percent less. The female labor market participation rate (55 percent) is also much lower than the OECD average (62 percent). The government's National Employment Strategy 2010 aims at boosting Korea's employment rate from 63 percent of the working age population in 2010 to 70 percent, including by raising the participation rate of women, the elderly, and youth.

Labor productivity growth is also being held down by rigidities in the service sector. Productivity growth in the service sector has been about 1 percent a year on average since 2001 compared to 6 percent in the manufacturing sector. The government can address this issue by enhancing competition, including in the education and health sectors; expediting bank-led restructuring of small- and medium-enterprises, the bulk of which are in the service sector; and eliminating preferential tax treatment of the export sector.

Figure 5 Public and Private Social Expenditure in Percentage of GDP in 2007



Source: OECD

The Korean government is targeting a balanced central government budget (excluding social security funds) by 2013-14, as part of its fiscal consolidation plan, which is already well advanced. Within this framework, the 2012 budget envisages a 20 percent nominal increase in social welfare spending. The Direction for the Preparation of the 2013 Budget, which was recently approved, also maintains workfare and sustainable growth as core themes. The government's National Fiscal Management Plan for 2011-15 lays out several areas to increase revenues. Going forward, better clarifying medium-term fiscal targets and linking them more directly to future liabilities, including those related to aging, would help ensure that the fiscal objectives are consistent with long-term sustainability. This would also help make them more binding and guide prioritization among fiscal measures. The key policy tools to address these medium-term fiscal challenges include pension and healthcare reform, broadening of the tax base, improved tax administration and some reallocation of public expenditures.

Conclusions

The global economy still remains fragile. Given its high global interconnectedness, Korea must remain vigilant. The main short-term risks to the outlook are the potential re-escalation of the euro crisis and possible increases in energy prices from geopolitical risks in the Middle East.

A re-escalation of pressures in heavily indebted economies in Europe could lead to further deleveraging by European banks, which if disorderly and large scale, could have serious implications for Korea. However, since 2008, the external vulnerability of the Korean financial system has diminished, reflecting higher international reserves, lower reliance on wholesale funding, reduced foreign exchange liquidity mismatches, the entry of new foreign investors in domestic bond and onshore dollar funding markets, and the introduction of macroprudential instruments. The Korean economy is also susceptible to energy price shocks, which could boost inflation and further weaken private consumption.

Korea continues to be one of the most dynamic economies in the most dynamic region of the world. It is, therefore, well placed to take up the challenges that could arise from a volatile global economy. Unlike many other countries, including the most advanced ones, Korea has ample policy space to deal with global shocks, thanks mainly to its low public debt, exchange rate flexibility, comfortable international reserve buffers, and use of macroprudential measures. Overall growth prospects remain favorable, and with the right policy settings, Korea can successfully navigate the still dangerous waters to a path of sustainable growth.

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1 Prepared by Thomas Rumbaugh, Division Chief, Asia and Pacific Department, International Monetary Fund. The views expressed are those of the author and not necessarily those of the IMF.

2 A previous IMF study shows that government gross debt will begin to grow from around 2020 as the initial asset accumulation phase of Korea's still young pension system (which is fully funded) matures. See Feyzioglu, Skaarup, and Murtaza (2008), "Addressing Korea's Long-Term Fiscal Challenges," IMF Working Paper 08/27 (Washington: International Monetary Fund) (http://www.imf.org/external/pubs/cat/longres.aspx?sk=21595.0).