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FUTURE PROSPECTS FOR THE KOREAN ECONOMY

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Abstract

Korea has shaken off some of the impacts brought by the Sewol ferry disaster, but its overall pace of growth is still very weak. The Korean economy is forecast to grow by 3.5 percent in 2015, slightly higher than 3.4 percent in 2014. But there are growing downside risks in the global economy. Domestically speaking, mounting household debts and falling corporate profitability have weakened the fundamentals of the Korean economy, and structural factors, such as demographic changes, have also had negative impacts. Not only that, Korea's inflation has been very low for quite a long time. Given weak domestic demand and low inflation in the midst of growing external uncertainties, expansionary macroeconomic policies are deemed necessary. Fiscal policy needs to remain expansionary and supportive of economic activity at a level that would not pose a threat to long-term fiscal prudence. Monetary policy should remain more alert and prepared for lower inflation. Since these short-term macroeconomic policies are not enough to sustain the dynamics of the Korean economy, aggressive and full-scale structural reform policies should be implemented in parallel so as to offset slow growth resulting from structural factors such as an aging population.

Overall Economic Activity

The sinking of the Sewol ferry in April 2014 significantly hurt consumer sentiment and stalled production growth in Korea. Korea has shaken off some of the impacts brought by the disaster, but its overall pace of growth is still very weak. The global economy is on a gradual recovery path, led by the U.S., but China, EU, and Japan continue to experience decelerating growth, implying no sign of fast improvement in external conditions. Domestically speaking, mounting household debts and falling corporate profitability have weakened the fundamentals of the Korean economy, and structural factors, such as demographic changes, have brought negative impacts, too.

Production in the service industry has maintained a low but moderate pace of improvement, whereas industrial production index remains low. The capacity utilization rate in manufacturing is at an extremely low level and the inventory-sales ratio is on the rise. In particular, the rise in inventory is due more to the fall in shipment resulting from weakening demand than to voluntary stockpiling by companies preparing for future demand. These conditions will later act to pose a hindrance to production expansion. The coincident composite index, which shows overall conditions of the Korean economy, has remained slightly above the base line (100) since the second half of 2013, but its recent readings dropped to 100, meaning that the pace of Korea's economic growth has not picked up. Also, the persistently low Business Survey Index (BSI) points to an expectation that it would take a very long time for the economy to improve.

In its economic outlook released in December 2014, the Korean Development Institute (KDI) expected that the Korean economy will grow by about 3.5 percent in 2015, slightly higher than 3.4 percent in 2014, primarily on account of moderate recovery in domestic demand and slightly higher export growth. It should be noted that this outlook, however, is based on the assumption that the global economy will restore the pace of growth as expected and domestic macroeconomic policies will be expansionary and implemented as planned and without disruptions. KDI assumed that the global economy will see growth at the high end of a 3 percent range in 2015, the same as the projections by the IMF and OECD, but pointed out that there are growing downside risks, given that uncertainties over the global economy have intensified further since the release of outlooks by the IMF and OECD, and that the euro area and China might grow slower than forecasted. If the global economy in 2015 will grow at about the same pace as in 2014, it is highly likely that the Korean economy will see its growth drop to the low 3 percent range.

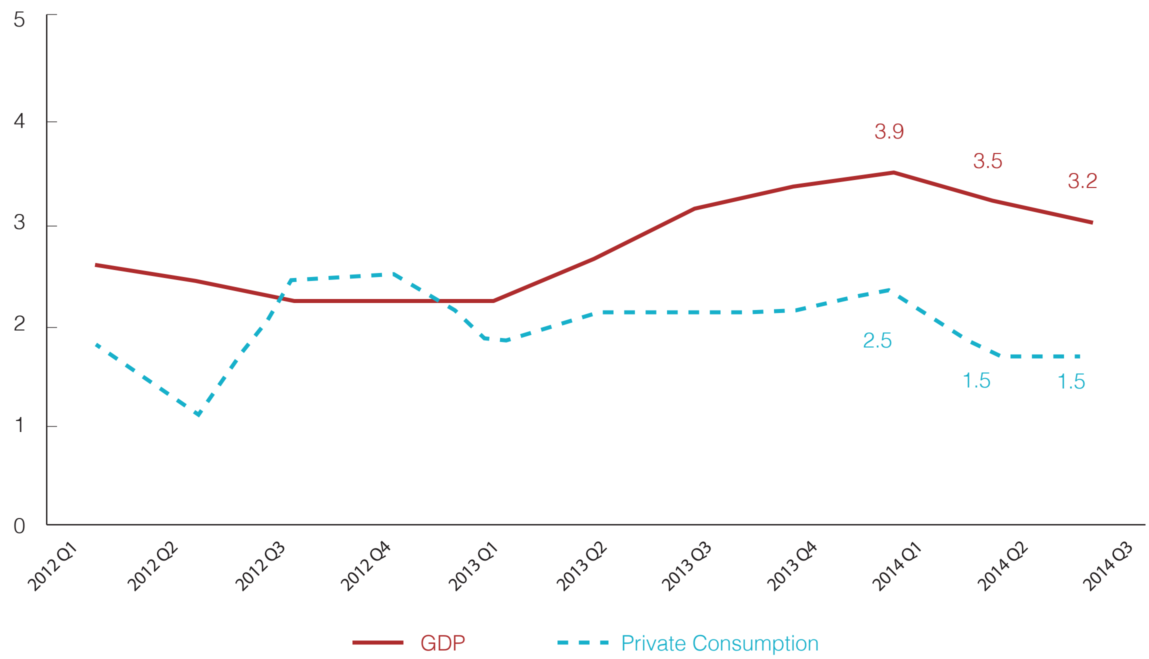
Rising household loans could pose another risk to the Korean economy. After government mitigated regulations on mortgages, household loans have skyrocketed. Thanks to yet low interest rates, debt burdens on households are not very high. However, since variable rate loans account for a considerably large share of total lending, an increase in market interest rates would lead to higher debt burdens, thereby causing a drag on the economy. The following sections present KDI's projections of economic activity by category.

Table 1 Domestic Economic Outlook (as a %, in $100 million)

	2014					2015		
	1/4p	2/4p	3/4p	4/4	Annual	1st half	2nd half	Annual
GDP	3.9	3.5	3.2	3.2	3.4	3.4	3.6	3.5
Total Consumption	2.6	1.5	2.0	1.7	1.9	2.7	2.5	2.6
Private Consumption	2.5	1.5	1.5	1.4	1.7	2.3	2.4	2.3
Total Fixed Investment	5.9	3.4	3.6	3.2	3.9	4.1	5.1	4.7
Equip. Investment	7.3	7.7	4.3	-0.3	4.7	2.5	4.1	3.3
Const. Investment	4.3	0.2	2.6	4.1	2.7	4.3	4.9	4.7
Exports	4.5	3.7	2.5	2.4	3.2	2.2	4.8	3.6
Imports	3.5	2.7	2.7	0.9	2.5	2.7	4.8	3.8
Current Account	151	241	225	288	905	387	504	890
Headline Inflation	1.1	1.6	1.4	1.0	1.3	1.5	2.0	1.8

Note: p denotes preliminary estimates of the National Accounts; columns without p are KDI's estimates.
Sources: Bank of Korea, National Accounts; KDI Economic Outlook, December 2014.

Figure 1 Changes in Real Gross Domestic Product and Private Consumption (as a %)



Source: The Bank of Korea.

Consumption

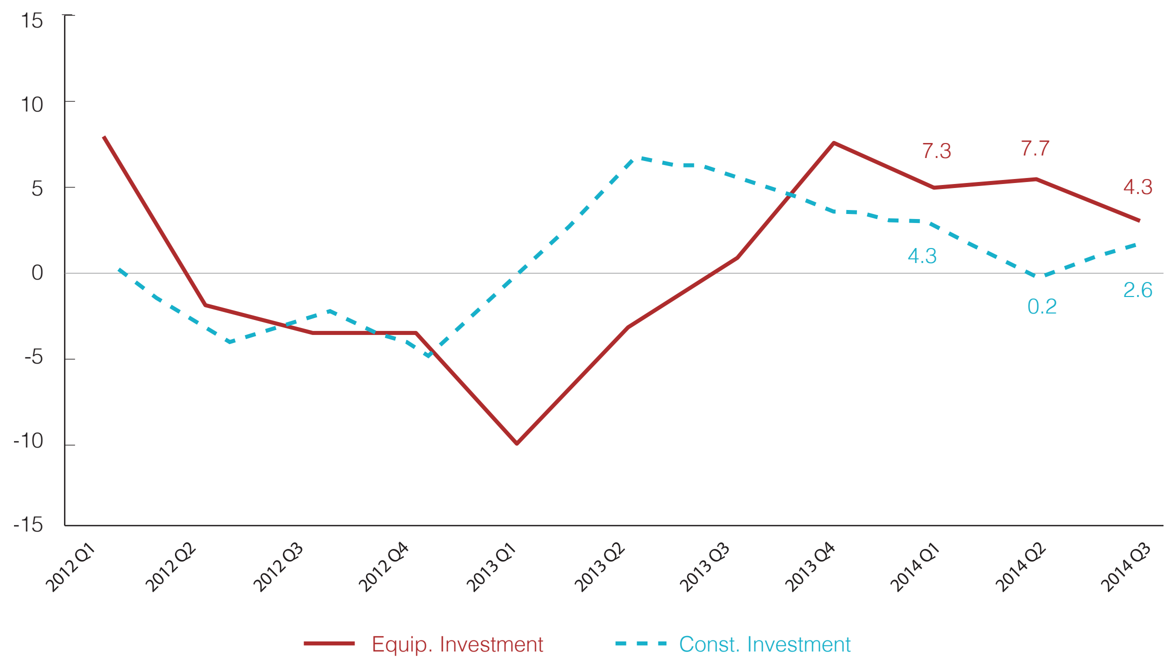
After the Sewol ferry disaster in April 2014, private consumption was in a slump with a growth rate in the mid-1 percent range from the second quarter of 2014, after gaining 2.5 percent growth in the preceding quarter and about 2 percent between 2012-2013. The contraction in consumer spending was then assumed to be temporary, but no significant rebound was observed in the third quarter of 2014.

The slump in private consumption has been driven by structural as well as cyclical factors. The real gross domestic income (GDI) in 2013-2014 expanded by about 4 percent on an annual basis, slightly higher than real GDP growth, on account of improved terms of trade brought by import prices collapsing, but the consumption growth was far below GDI growth. One structural factor behind waning private consumption is the decreasing share of allocation to households. The share of household income in gross national income (GNI) was 68 percent in 2000, but has subsided to around 60 percent since 2010. Assuming the need to strike a balance between income and expenditure in the long run, a decline in income would result in the decline in spending. Another structural factor is an aging population resulting from an increase in life expectancy. People began to live much longer, but their working period has not been extended enough to keep up with the increase. Households in the face of such condition are inclined to seek more savings in order to prepare for their post-retirement years. Compared with a decade ago, propensity to consume (the proportion of disposable income which households spend on consumption) decreased in all age groups and showed a particularly steep drop in the elderly aged 60 and over. These two factors are not only structural but also long term, hence difficult to be solved in the short term. This implies that private consumption will stay below GDP growth for a while to come. Moreover, in the second half of 2014, household debts mounted at a fast pace, causing higher debt burden on households, consequently serving to weaken households' consumption capacity. In this regard, private consumption is projected to increase by 2.3 percent in 2015, slightly higher than 1.7 percent in 2014, shaking off negative impacts of temporary factors (Sewol ferry disaster). Still, the growth of private consumption is expected to hover by 1 percentage point below the GDP growth.

Fixed Capital Investment

Equipment investment has increased by around 7 percent in the first half of 2014 and about 4 percent in the third quarter. The growth rate itself is high, but the increase was mostly attributed to the base effect of the fall of 1.5 percent in 2013, implying continued sluggishness in equipment investment. The contraction in 2012-2013 can be seen as the outcome of large-scale investment made in electrical and electronics

Figure 2 Changes in Equipment and Construction Investments (as a %)

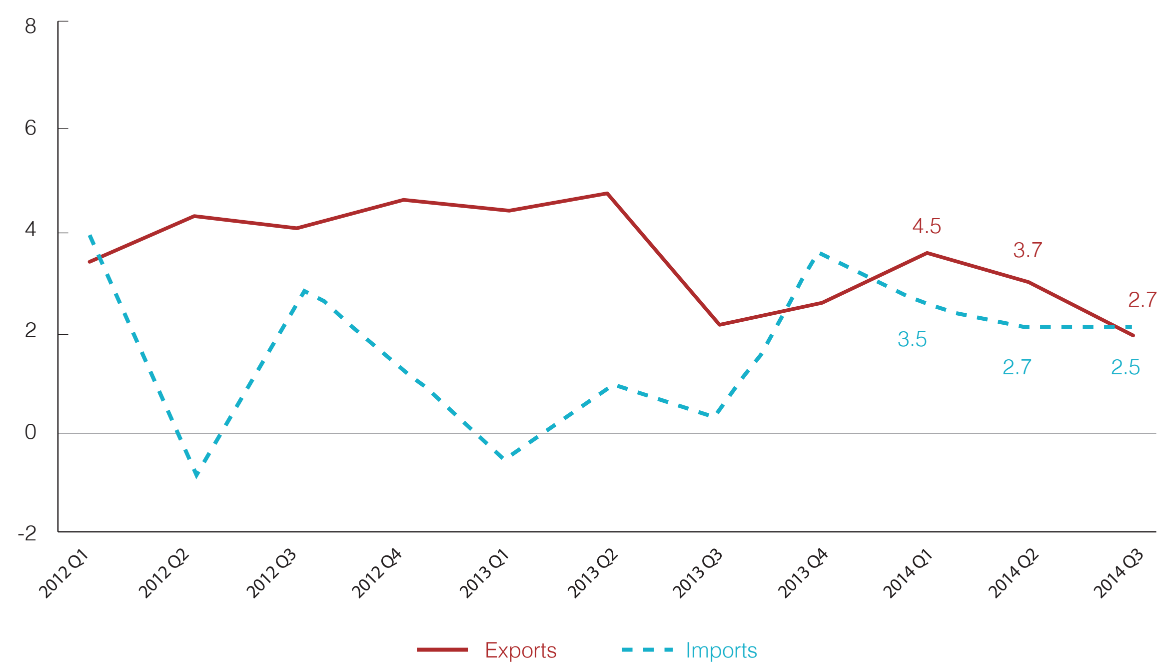


Source: The Bank of Korea.

industries in 2010-2011, when the Korean economy began to recover from the global financial crisis. As the competition in markets for semiconductor and LCDs grew fiercer, more and more companies scrambled to build new large-scale facilities for strategic reasons. Since then, the demand for equipment investment in electrical and electronics industries has decreased, and hence relatively less investment was made in 2012-2013. The year 2014 showed a mere recovery and more uncertainties at home and abroad, discouraging aggressive investment. The average capacity utilization rate was roughly 80 percent in 2010-2011, but fell to the mid-70 percent range in the second half of 2014. The recent gradual increase in the inventory-sales ratio might serve to hamper production later. With many plants idle, a fast recovery of corporate demand for equipment investment is hardly expected. Not only that, corporate growth has shown a clear decline in recent periods. The rate of sales increase, at 10 percent or higher in 2010-2011, was recorded at -0.7 percent year-on-year in the first half of 2014, down further from 0.7 percent in 2013. Corporate profitability has deteriorated, too. The operating income-to-sales ratio was recorded at 4.7 percent in the first half of 2014, down by 0.4 percentage point from 5.1 percent a year ago. The decline in corporate profitability in the midst of falling growth has weakened investment capacity. Growing uncertainties in the global economy are another factor that makes it hard to expect a rebound in equipment investment in 2015. Equipment investment was projected to grow at a rate of 4.1 percent in 2014 and then at a slightly lower rate of 3.3 percent in 2015.

On the other hand, a somewhat positive outlook is expected in construction investment which has been in a long slump since the global financial crisis. In these periods, earnings of construction businesses dropped continuously and even posted a deficit in 2013. This downward trend, combined with delayed restructuring of the industry, has brought many companies to insolvency. Construction investment rebounded to expand by 6.7 percent in 2013, thanks to the base effect, but showed continuing sluggishness with a year-on-year growth of 1.9 percent in the first half of 2014. On the bright side, the real estate market has shown stimulation signs since deregulation on loan-to-value (LTV) and debt-to-income (DIT) and falling interest rates in the third quarter of 2014. Transactions of real estate increased, the number of unsold new house units decreased, and house prices are on the rise. Construction orders received as a leading indicator of construction investment increased fast in the third quarter of 2014, hinting at a certain degree of recovery in the future. Taken together, the construction investment is projected to grow by about 4.7 percent in 2015, up from 2.7 percent in 2014.

Figure 3 Changes in Exports and Imports (as a %)



Source: The Bank of Korea.

Exports and Imports

As the global economy entered a gradual recovery phase, Korea's exports expanded at a relatively strong pace with the low end of 4 percent range in 2013 and in the first half of 2014. Korea's export growth to the U.S. showed a temporary slowdown in the first quarter of 2014, but the pace soon picked up on account of economic recovery in the United States. On the other hand, export growth to China, Korea's largest trading partner—accounting for 26.1 percent of total trade in 2014—decreased in 2014, reversing the increase of 8.6 percent in dollar terms as of 2013. As the Chinese economy grows and matures, its growth is gradually slowing down, which is natural. This means that a rapid growth in exports as in the past might no longer be sustainable, and structural changes in the Chinese economy in the midst of its economic maturation is more likely to bring increasing burdens on Korea's exports. China's investment and debts have risen at a fast pace since the onset of the global financial crisis. In recognition of risks linked to overinvestment, the Chinese government has taken policy actions to achieve a smooth transition towards a consumption-oriented economic growth. According to KDI's analysis, Korea's exports to China are more closely linked to investment than they are to consumption. Therefore, China's downward revision of investment amount as well as its overall slowing growth could have negative impacts on the Korean economy. Not only that, exports to the EU and Japan showed continuing slowdown. Given the persistently low inflation and high unemployment rate in the EU, its economic recovery is not expected to come shortly. Japan has implemented a series of economic stimulus policies, known as Abenomics, but nevertheless negative impacts from the sales tax hike have turned out larger than expected, putting a drag on economic recovery. Japan's macroeconomic policies might bring in positive influence on its economy in the short run, but without active efforts for structural reforms in coming years, Japan is more likely to experience continued slowdown, which could pose negative impacts on Korea's exports.

Looking at Korea's exports by product category, semiconductors showed a robust growth in 2014, while other flagship products including wireless communication devices, automobile-related items and petroleum-related goods, showed continued weakness. Fast catch-up of China and other latecomers in markets for these products has raised concerns that Korea might face difficulties in sustaining its export competitiveness. Following the IMF and OECD, KDI assumed that the global economy will grow by about 3.3 percent in 2014 and by a high end of 3 percent in 2014. The IMF and OECD projected that global growth will be uneven across regions, but overall recovery is expected to be led by the US. Also, provided that the US monetary policy will be normalized during 2015, the real effective exchange rate of the won is assumed to decline by around 5 percent. Based on this assumption, KDI expected that Korea's exports will expand by 3.6 percent in 2015, higher than 3.2 percent in 2014.

Since the release of forecasts by the IMF and OECD, downside risks have been growing, triggering more uncertainties in the global economy, and thus it is becoming increasingly more difficult to expect a growth at the high 3 percent range. In this context, it can be said that relatively large downside risks exist in KDI's projection of Korea's exports.

Imports are projected to grow by 3.8 percent in 2015, higher than 2.5 percent in 2014, as domestic demand in 2015 is likely to improve, albeit moderately. However, falling prices of international raw materials, including crude oil, would make the import value in dollar terms as of 2015 to stay similar to that in 2014. The current account is projected to run a huge surplus for a long time as domestic demand is weak due to structural factors such as an aging population. These conditions, coupled with improved terms of trade resulting from falling crude oil prices, are expected to contribute to a large surplus of $90 billion (6 percent of GDP) in the current account in 2015, similar to in 2014.

Labor Market

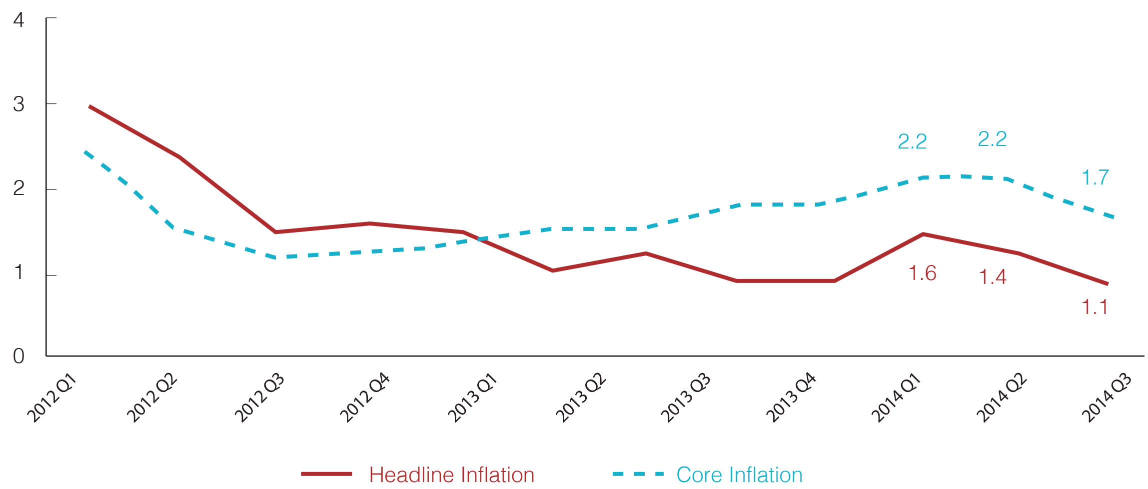
The labor market witnessed a steep rise in the number of employed persons after the year end of 2013. As the demand for labor has increased, particularly in the sector for human health and social work activities, and as government programs, such as the time-selective job system, started to bring in some positive results, the number of employed persons increased by 500,000 in the second half of 2013, higher than 300,000 in the first half, and then it expanded by 600,000 in the first half of 2014. The pace of increase slowed in the second half of 2014, but remained strong. The increase was markedly strong among the elderly aged 50 or over and temporary daily workers. Thanks to such increase, the employment rate (aged 15-64) rose fast to 65.4 percent in 2014, up from 64.5 percent in 2013. The rise itself is quantitative expansion and is deemed positive, but the fact that the rise was mostly driven by temporary, daily, and part-time workers implies that qualitative improvement might have not been secured. It is estimated that the number of employed will rise by slightly more than 400,000 in 2015, which is somewhat down from 2014 (marginally above 500,000), but means continued strength of quantitative increase. Despite the rise in the employment rate, the unemployment rate in 2015 is projected to be 3.5 percent, similar to 3.6 percent in 2014, due to the increase in job-seeking activities.

Inflation

Korea's inflation has been very low for quite a long time. On a quarterly average basis, headline inflation has run below 2 percent since the third quarter of 2012 and recently receded close to 1 percent. Given that the inflation target for 2013-2015 is 2.5-3.5 percent, Korea's inflation has consistently come in far below the target for a very long time. Such low inflation is partially due to lower prices of agricultural and petroleum products than a year ago. However, core inflation, excluding agricultural and petroleum products, peaked at only 2.2 percent over the same period, and recently dropped to the midpoint of 1 percent. This implies that supply factors are not enough to explain low inflation. There might have been other temporary factors, such as government subsidies on childcare and free school meals in 2012-2013, but even in 2014 without the subsidy effect, inflation ran low, meaning problems now faced by monetary authority are quite severe. Waning growth in domestic demand might be a demand-side factor that could explain the low inflation. When inflation is low and growth slows down, it would be natural for the authority to respond to the situation by aggressively lowering the base rate. KDI's analysis however found that Korea's monetary authority has been reluctant to take active policy measures, relying on its optimistic forecast of economic growth and inflation. The real interest rate (nominal interest rate net inflation rate) has even risen since 2012. According to the analysis, Japan's monetary authority on the edge of a severe recession in the 1990s opted for laid-back policies relying on optimistic views, which was one of the factors that led Japan into a long deflation. Korea's GDP deflator—which measures the prices of products in the entire economy and hence is a broader measure than headline inflation—was recorded at zero percent year-on-year in the second and third quarters of 2014. Korea's GDP deflator growth precedes its headline inflation, implying that low inflation will be prolonged.

According to the demand-side inflationary pressure expected for 2015, Korea's domestic demand is projected to improve moderately and its output gap (actual GDP net potential GDP), currently negative, is likely to gradually close. On the supply side, however, inflationary pressure is projected to be very low, such as slow wage growth and falling prices of international raw materials such as crude oil. Therefore, Korea's inflation is expected to remain far below its target range of 2.5-3.5 percent in 2015. When excluding temporary impacts from government policy for the price hike in cigarettes, headline inflation is projected to run at the low end of one percent in 2015. (The 80 percent hike in the price of cigarettes is expected to increase headline inflation by 0.6 percentage point.)

Figure 4 Headline and Core Inflation (as a %)



Note: Data for the fourth quarter of 2014 refer to October and November.
Source: Korean Statistical Information Service.

Conclusions and Policy Recommendations

Korea is projected to grow at a moderate pace if domestic and external conditions remain conducive. Continued moderate growth in the global economy and low oil prices will have positive impacts on the Korean economy. There are of course lingering concerns about growing downside risks in the global economy and mounting household debts in the Korean economy. Also, structural factors such as an aging population are going to make it difficult for the Korean economy to enjoy rapid growth in the future.

Main policy recommendations that may be inferred from the above projections are as follows. Above all, given continuing weak domestic demand and low inflation in the midst of growing external uncertainties, a certain extent of expansionary macroeconomic policies are deemed necessary. Fiscal policy needs to remain expansionary and supportive of economic activity at a level that would not pose a threat to long-term fiscal prudence. Monetary policy should remain more alert and prepared for lower inflation. As inflation has run below the target rage (2.5-3.5 percent) for a long time, there might be a weakening of confidence in the monetary authority and gradual decline in inflation expectations. The monetary authority should put in more policy efforts to achieve its inflation target, since the decrease in inflation expectations would not be restored easily.

These short-term macroeconomic policies are not enough to sustain the dynamics of the Korean economy. Aggressive and full-scale structural reform policies should be implemented in parallel so as to offset slow growth resulting from structural factors such as an aging population. In this context, it is essential that the government carry out its 3-year plan for economic innovation as scheduled.

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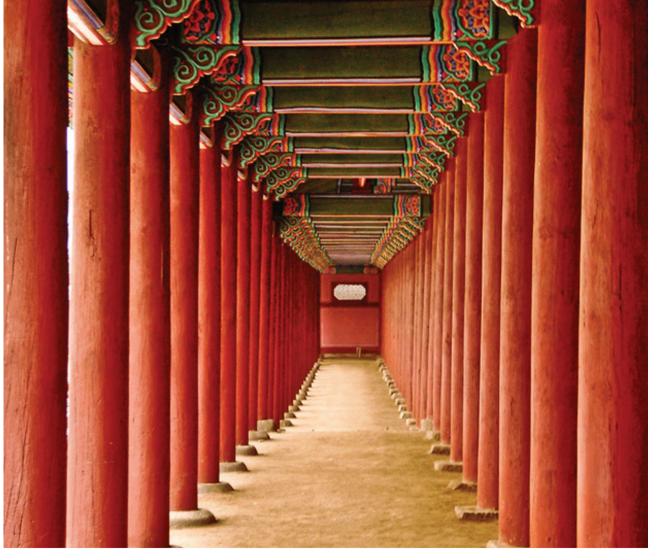

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