OVERVIEW AND MACROECONOMIC ISSUES

TOWARD FURTHER CONVERGENCE? KOREA'S CURRENT ECONOMIC PROSPECTS AND POLICY CHALLENGES

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Abstract

The Korean economy has fared well despite the recent global market turmoil and is well positioned to benefit from the global recovery given its strong fundamentals and skilled policymaking. But the country must rebalance its economic structure if it is to continue raising its population's standard of living in an inclusive way and approach the income levels of the richest advanced economies.

Bold and politically difficult reforms are needed, including revamping the fiscal framework to better support rebalancing of growth toward domestic demand, strengthening of the social safety, deregulating the services sector, and addressing labor market duality while promoting greater labor market participation by female and aged workers.

The Outlook: Full Recovery is in Sight But with Downside Risks

Korea's GDP growth is expected to rebound to 2.8 percent in 2013, from a 2 percent low in 2012. In 2010, a sharp post-crisis rebound in exports led to an impressive 6 percent growth rate. But then the economy experienced a two-year slowdown, closely mirroring the shaky and winding path of the global recovery.

This trend reflected Korea's very open economy. However, Korea's response to swings in the global economy, particularly in recent years, demonstrates that it tends to expand more during recoveries—and likewise slow down more during retreats than the world economy.

There are two plausible explanations for this. First, Korea's export portfolio is heavily concentrated in its flagship products, which are highly sensitive to business cycles. For example, Korea is still the world's number one exporter of ships, despite the threat posed by Chinese shipyards, which are rapidly catching up. And global shipbuilding order cycles are known to be highly cyclical. They also depend heavily on financial conditions in Europe, which took an extraordinary hit during the 2008–09 global financial crisis and the sovereign debt crisis that followed. Korea's major electronic products, such as memory chips, liquid crystal displays, and high-end durable consumer electronics are also subject to volatile swings in global prices and inventories. Second, structural factors dragging on domestic demand built up over time and seem to have made the domestic demand momentum more vulnerable to external factors. Structural weaknesses include high household debt, a housing stock overhang, weak household income generation, and growing income inequality and a weak social safety net.

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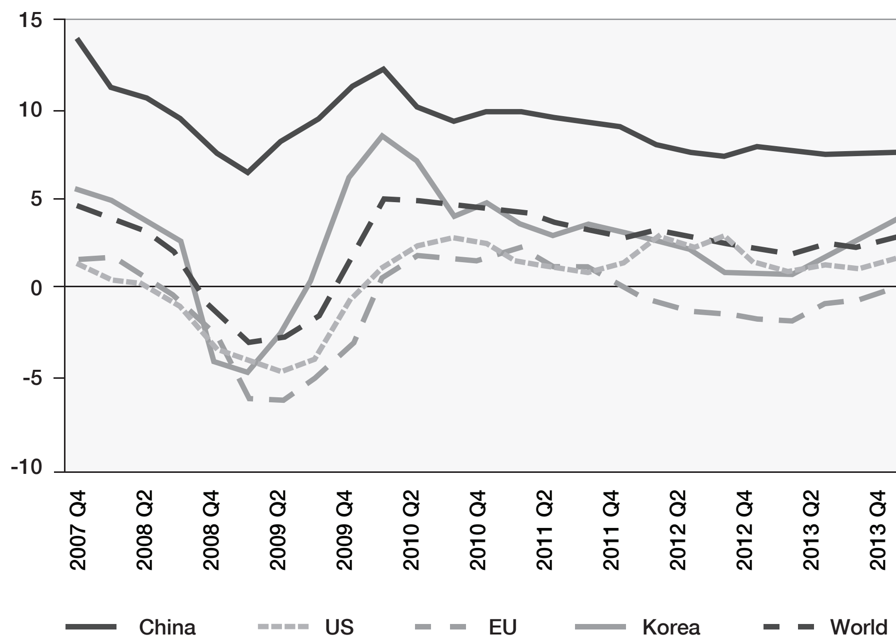
Since late 2012, there are increasing signs that the economy has bottomed out, in line with stronger growth of Korea's main trading partners, especially the United States and the European Union. The most recent evidence corroborating this was the GDP data for the third quarter of 2013, which

Figure 1 Korea: GDP Growth (as a %, year over year)



Source: IMF, World Economic Outlook.

surprised on the upside. It reported two consecutive quarters of more than 1 percent growth over the previous quarter, a level generally considered to be at full throttle.

Based on the current trend, the projected recovery in global growth would further strengthen Korea's GDP growth to 3.7 percent in 2014. However, in the near term, absent reforms, private domestic demand momentum is expected to remain relatively weak, for reasons explained further below.

The financial sector is sound overall. Bank vulnerability to external liquidity shocks has declined as macroprudential regulations have markedly reduced their short-term external debt. Banks are highly capitalized and their nonperforming loan ratios are low. However, bank profits remain low, and weak repayment capacity of some households could further erode profits. A similar risk also stems from parts of the corporate sector.

Meanwhile the global environment is full of risks. Korea is unlikely to be affected much by mild turmoil from U.S. monetary policy normalization, but adverse growth surprises in any of its main export markets—China, the United States, and the European Union—or more severe market stress would mean a significantly grimmer outlook. Korea emerged as a safe haven of sorts during the market turmoil of summer 2013. Low inflation, a strong fiscal position, and ample foreign reserves have strengthened Korea's attractiveness to risk-averse investors, including many central banks and sovereign wealth funds. However, the robustness of this new safe haven status has not been tested.

Box 1 How Vulnerable Would Korea be to Quantitative Easing Tapering?

The strengthening of the U.S. economic recovery, including recent upbeat labor market indicators, is a reminder that QE tapering will not be delayed indefinitely.

So far, Korea has done remarkably well, clearly differentiating itself from emerging markets, which have generally suffered capital outflows since May 2013, when fears about tapering uncertainty began to surface. In fact, Korea has attracted significant inflows of both equity and bonds since then. This was partly because international investors have redirected their funds from emerging markets with large current account deficits and financial excess.

This is quite an amazing break from the past. Since the liberalization of the capital account in the early 2000s, Korea has often been labeled by market analysts as a high financial beta market, meaning that its asset prices are highly sensitive to fluctuation in global risk appetites. So why have global investors behaved differently this time? There seems to be a number of interconnected reasons:

- First, the overall resilience of Korea's financial system to external shocks has significantly increased since the 2008–09 global financial crisis, particularly because its banks have slashed their external short-term debt, which used to be their key vulnerability to swings in capital flows.
- Second, Korea's post-crisis rebound in equity prices has been very modest compared with many emerging markets that enjoyed a surge. And Korea-specific factors that dragged on equity began to fade in summer 2013.
- Third, bond flows are driven by an increasingly diversified investor base and are hence more stable. Moreover, our analysis using post-crisis data suggests that these investors tended to increase their Korea exposure when the global market became more risk averse, at least up to a threshold.
- Fourth, with a large current account surplus and the market's perception that the authorities are pacing the appreciation, market participants overwhelmingly seem to expect that the won will only appreciate.

Given these considerations if QE tapering takes place in an orderly fashion, driven by the recovery of the U.S. growth outlook, portfolio capital flows are likely to continue as Korea's economic outlook strengthens.

A disorderly tapering, leading to severe market stress, could cause a shock to both the growth outlook and capital flows however. But Korea has significantly larger policy space than other countries to respond.

The new government has been wisely vigilant regarding external risk management, including through macroprudential regulation and close monitoring. We believe that Korea's macroprudential measures have done much to curtail foreign exchange liquidity risks in the banking system.

Policy Mix: Appropriate So Far, But More Needs to Be Done

Korea's economic team has proved its skill in navigating the still stormy waters to recovery. The new team appears to have focused mainly on three objectives so far: supporting the economic recovery, staging creative economic initiatives, and managing both domestic and external risks to growth and financial stability.

Regarding the first objective, the government submitted a supplementary budget (1¼ percent of GDP) in May to Parliament, which adopted it. The 2014 budget proposed to the National Assembly keeps the overall deficit (excluding social security funds) unchanged from the 2013 supplementary budget (at 1.8 in percent of GDP) and allows a slight increase in debt.

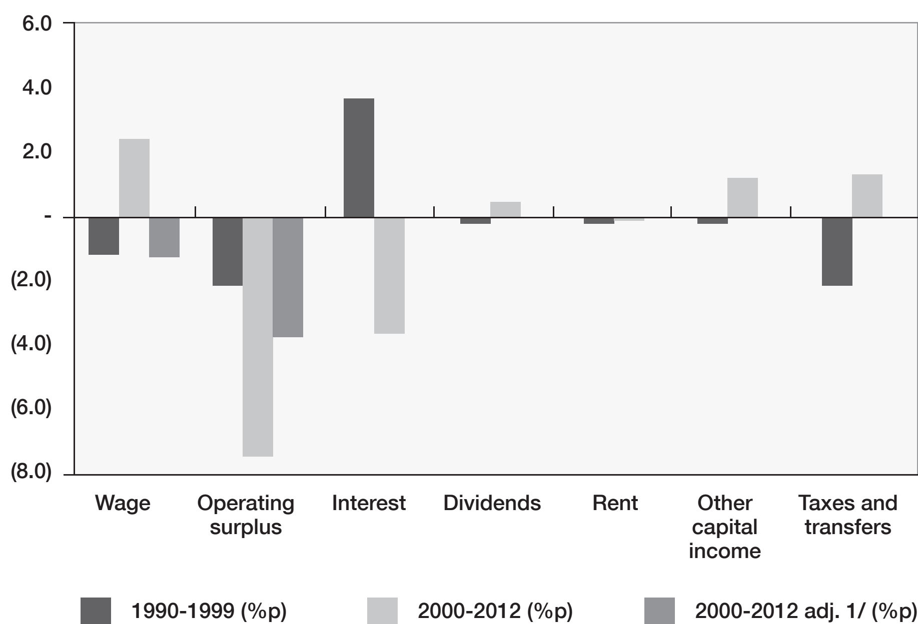
In tandem with the fiscal support, the Bank of Korea cut its policy rate to 2.5 percent in May 2013, which was appropriate given the uncertainty of the global outlook, the continued negative output gap, and subdued inflation.

The policy actions taken so far have been timely and appropriate, in our view. However, we believe that Korea's macroeconomic policy framework can benefit from enhanced flexibility, particularly on the fiscal policy side. Currently, the government is required by law to include its annual borrowing ceiling in the budget. And the ceiling is sealed once Parliament approves the budget. The administration can then raise the borrowing ceiling only by a supplementary budget. However, a supplementary budget is not an easy undertaking—partly because of stringent legal requirements that must be met (for example, natural disaster, war, recession).

Such a stringent budget framework, of course, gives a powerful tool to the legislature to keep government spending and debt in check. The downside, however, is a perpetual risk of a spending cut during an economic slump Whenever the economy slows, causing a significant shortfall in tax revenue compared with what is forecast by the budget, there is a risk of an automatic spending cut (absent a supplementary budget), which exacerbates the slowdown. Korea may be better served by a move to a structural balance rule, which will allow the government to automatically loosen its budget stance in a downturn and tighten in an upturn.

We also see an important need to carefully review Korea's fiscal space. Korea's government debt has increased from about 30 percent to 34 percent since the global financial crisis. And the government is under intense pressure, both from Parliament and the general public, to avoid a further increase in the debt-to-GDP ratio. While fervor in fiscal discipline is laudable and sets an example for many economies suffering heavy debt, beyond

Figure 2 Drivers of the Decline in Household Income Share (% of GNI)



Note: Adjusted for changes in the proportion of self-employed in the employed.
Source: Bank of Korea ECOS system and IMF staff estimates.

a certain point, the benefits of prudence do not necessarily outweigh the constraints it imposes on policy making, in particular the ability to use fiscal policy to help rebalance the economy and set it on a sustainable high-growth path.

Given the new government's dilemma over its social spending pledges and commitment not to raise taxes, a judicious and well-controlled use of Korea's fiscal space should receive serious consideration. In fact, we believe that the central government balance could be safely reduced for a while which would free up resources to finance growth-enhancing social spending. Moreover Korea has ample scope to raise more tax revenue, mainly by expanding the tax base, given that the tax law allows excessively large exemptions.

The current weakness in Korea's domestic demand seems closely connected to falling household income generation, which has been driven by both structural and cyclical factors, as the next section discusses.

Less Upbeat Longer-Term Prospects

In the longer run, weak household income growth, de-leveraging needs, and conservative fiscal plans mean that demand is likely to remain highly dependent on net exports. On the supply side, a rapidly aging population will be a drag on growth potential.

Medium-Term Challenge: Rebalancing to Domestic Demand

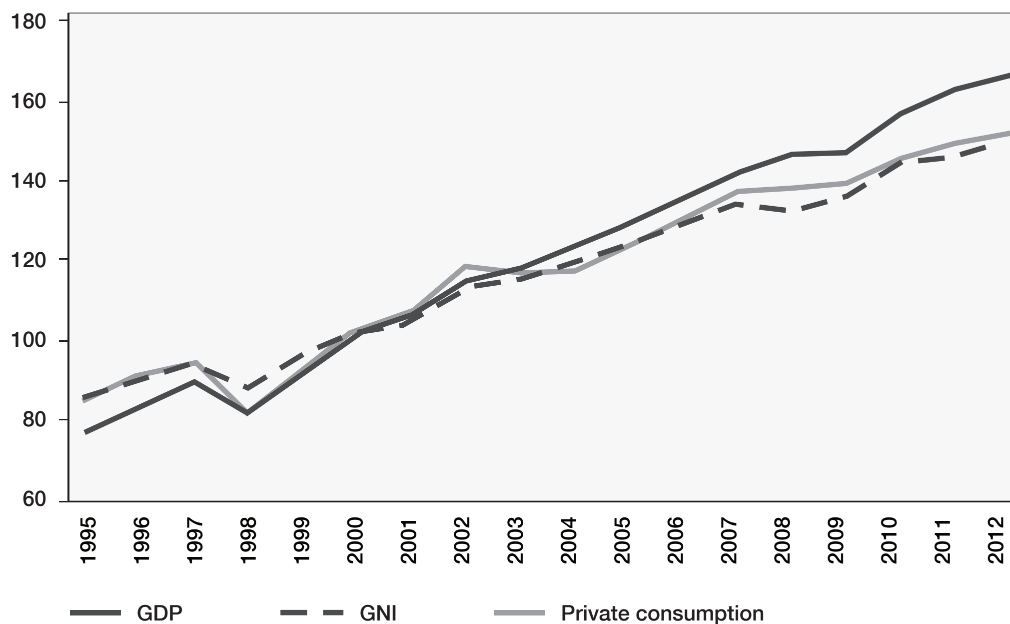
Reviving domestic demand is not only crucial to avoid a durably sluggish economy. It is crucial for another important reason: diversifying the engines of growth would reduce Korea's high sensitivity to global cycles. It would also help alleviate income inequality, which has risen as the affluence enjoyed by export-oriented large manufacturers failed to spread to the rest of the economy.

Korea's dependence on external demand has increased since the mid-2000s. Meanwhile, household and corporate indebtedness has continued to increase.

Since the early 2000s, the growth of household disposable income has lagged behind that of real GDP. Households' slice of the growth pie has shrunk: their share of gross disposable income fell by 5.5 percentage points during 2000–12. During this period, the share of nonfinancial and financial corporate disposable income (equivalent to the amount of corporate savings) increased by 4.5 percentage and 1.4 percentage points, respectively.

Increased corporate savings is a common recent phenomenon in the region, as well as in many advanced economies, although Korea appears to lean to the high side. The decline

Figure 3 Real GDP, GNI, and Private Consumption (2005 *won*, 2000=100)



Source: CEIC Data Company and IMF staff estimates.

in the overall share of household income was largely led by a decline in Korea's labor income share (including self-employed income). In addition, the terms of trade, the ratio between what Korea can charge for its exports and what it pays for imports, has continued to worsen, significantly eroding the purchasing power of Korean households. The deterioration is mainly a result of the secular rise in global oil prices.

Households have responded to the decline in disposable income growth by saving less and, in lower income households, reducing consumption. The average growth of private consumption remained at 3.7 percent since 2000, about ½ percentage point below the GDP growth rate. During the same period, the household savings rate fell by 4 percentage points to 4.7 percent.

The weakening income of households has put a drag on domestic demand through several channels, including lower household expenditure on services, with an immediate knock-on effect on the earnings of the self-employed; lower construction investment, due to households' worsening ability to service their mortgages; and higher household debt.

What can be done to mitigate these self-reinforcing negative dynamics? While there is no silver bullet, a more countercyclical fiscal policy, buttressed by higher social spending can make an important difference.

A stronger social safety net would enable households to reduce precautionary saving, freeing up room for consumption.

In the longer term, the most sustainable way to strengthen household income generation is through increased labor productivity. There is a big split here as well—between workers in world-class companies such as Samsung and millions of mom-and-pop businesses and self-employed people, between regular and irregular workers in the same company, between workers in a chosen career and those who are forced by early retirement to open yet another chicken house.

Tackling this split will require bold structural reforms, some of which also have fiscal costs.

Longer-Term Challenge: Arresting the Decline in Potential Growth

Korea's potential growth has been on a declining trend for some time. According to our estimates, Korea's potential growth decreased from 4¾ percent during 2000-07 to about 3¼ to 3 ½ percent in 2011-12. Future population aging is projected to be a major further drag on potential growth.

If Korea's demographic trends continue, it is projected to become one of the oldest countries in the Organization for Economic Cooperation and Development (OECD) by 2050, as the population is projected to age rapidly. Following

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current demographic trends (based on UN population projections) and in the absence of comprehensive reforms, Korea's potential growth will decrease to about 2 percent by 2025. In this case, the convergence of Korea's GDP per capita to that of the United States would cease at the present rate of about 65 percent.

Labor market duality and underutilization of segments of the population are impediments to growth.

First, Korea's low labor force participation presents a drag on labor inputs thereby depressing potential growth. Korea's employment rate is below the OECD average, particularly for women and youth (53.5 percent and 24.2 percent, respectively—3.5 and 15.1 percentage points below OECD averages).

Second, the labor market in Korea is segmented between regular and nonregular workers. The share of nonregular workers (which includes temporary and part-time workers) is very high (one-third of the labor force). The share of temporary workers in Korea is about 24 percent, compared with the OECD average of about 12 percent.

Another drag on potential growth results from the large gap between productivity in the manufacturing and services sectors. Korea has a world-class manufacturing sector, while the service sector has lagged behind. The productivity gap between the services and manufacturing sector is the largest among OECD countries, with service sector productivity just about half that of manufacturing. (The OECD average is 87 percent.)

Lackluster productivity in the service sector is closely intertwined with the state of small and medium enterprises (SMEs), which account for a bulk (90 percent) of service sector employment. SMEs rely excessively on government support in the form of public guarantees, which were stepped up during the 1997 and 2008 crises but never rolled back. This hinders the efficient allocation of resources by incentivizing firms to remain small and inefficient.

The challenge of lower growth potential will require a multipronged effort to address these shortcomings. These include labor market reform focusing on enhancing labor force participation, particularly of women and youth; addressing the problem of mismatched skills; and reducing excessive

employment protection; deregulation, particularly in the service sector; increased investment in the services sector; and the restructuring of SMEs.

The government has already embarked on a comprehensive reform agenda to address these issues. It is also encouraging to see that the new government's creative economic initiatives seem to support starting and closing businesses, including through enhanced risk sharing by the capital market, rather than through traditional policy lending.

An important related issue is the retirement age. According to recent studies, Korean workers are forced out of their primary job at the age of 54, on average. Most of these workers continue to work, due to insufficient retirement savings. And about 70 percent of them end up resuming work in an area that is unrelated to their primary career. This leads to skills mismatch and overcrowding of small businesses in the service sector. Retirement uncertainty also drives precautionary saving.

In May 2013, the Federation of Korean Trade Unions, Korea Employers Federation, and the government came to a grand agreement (Tripartite Jobs Pact to Achieve 70 percent Employment Rate). In a nutshell, the employers agreed to a legally protected minimum retirement age of 60. In exchange the trade union agreed to a performance-based wage or wage peak system. This is a very important step in the right direction. However, implementation of the latter step is all but assured, as it will be left to be negotiated at the firm level, and one of the two major unions disagrees.

Can Korea Overcome its Challenges Again?

All of the challenges above are considerable, and call for decisive and timely actions, many of which can be politically unpopular and thus require strong political will. So can Korea make this happen again? We are cautiously optimistic for two reasons.

First, since the early 1960s, when Korea embarked on its journey to economic prosperity, the country has always surprised outside observers by its ability to adapt its growth model to structural changes from within and without. The deeply polarized political landscape, combined with the revised legislative framework, which makes it very difficult to pass a law without bipartisan agreement, can make it difficult to move ahead with controversial reforms. However, there is an ever increasing social consensus on the direction of needed reforms. Political leadership will be key to transforming the consensus into action in the face of fierce resistance from special interest groups.

Second, Korea has the luxury of ample fiscal space to enhance its social safety net. This is the single most important precondition for any reform that may crumble barriers through creative destruction of both jobs and businesses.

Korea is one of a few countries that has successfully escaped the middle-income trap. History indicates that there is good reason to believe that Korea will succeed in making the efforts needed to continue to move closer to the top of the high income club.

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