



## **PART I: OVERVIEW AND MACROECONOMIC ISSUES**

### **WHAT LIES AHEAD? KOREA'S LONG-AND SHORT-TERM CHALLENGES<sup>1</sup>**

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#### **Abstract**

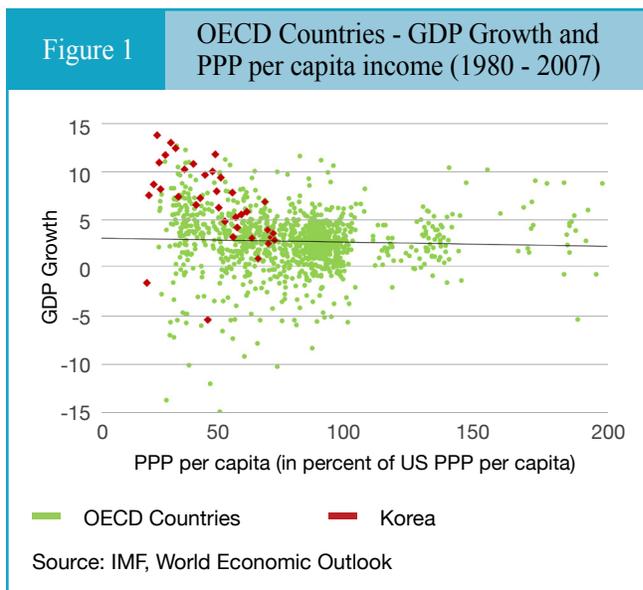
For decades Korea has had a remarkable track record of economic performance. But growth has now declined, and Korea may find it difficult to move quickly to the OECD income frontier. Moreover, Korea faces serious structural challenges, many of which will imply a further decline in potential growth. These include demographic shifts, export dependence, structural weakness and corporate vulnerabilities, and the labor market. With the economy facing major structural headwinds, a comprehensive set of measures are needed in a number of areas, including corporate restructuring, labor market reform, and productivity enhancement.

## Structural Headwinds Weigh on Korea's Future Income Convergence

For decades Korea has had a remarkable track record of economic performance. The government-guided export-promotion strategy was very successful, yielding an average growth of more than seven percent for nearly 50 years. Per capita income surged from five percent of that of the United States in 1960 to around 55 percent by the time of the global financial crisis. Within two generations, Korea vaulted into the OECD, its goods and services became known around the world, and its national corporate champions entered the ranks of the world's most recognized companies. At the same time, the fruits of this success were widely shared. The land reform in the 1950s, low-cost education, a dynamic business environment and high social mobility helped facilitate an egalitarian development path.

But growth has now declined, and Korea may find it difficult to move quickly to the OECD income frontier. The economy has suffered a series of exogenous shocks since the global financial crisis, but underlying growth prospects also appear to have weakened. Potential growth has dropped quite dramatically— from seven percent in the early 1990s to less than three percent now. Moreover, Korea faces serious structural challenges, many of which will imply a further decline in potential growth. These include:

- *Demographics.* Korea is also one of the world's most rapidly aging societies. The fraction of the population that is of working age is projected to peak in 2017 and decline rapidly thereafter, depressing potential employment and growth. The overall population is expected to start declining after 2025, with negative implications for domestic demand.
- *Export dependence.* Korea's economic success came on the back of exports, but that heavy reliance may now be a liability in a world of slowing trade. With exports exceeding 50 percent of GDP—one of the highest shares among advanced economies—Korea is heavily exposed to spillovers, particularly from China, its largest trading partner. China's slowing growth, rebalancing toward domestic demand, and moving up the value chain will all affect Korea substantially.
- *Sectoral weaknesses and corporate vulnerabilities.* Some of the heavy industrial sectors that underpinned Korea's past growth—for instance, shipbuilding, shipping, steel, and petrochemicals—are now facing bleak prospects globally given the trade slowdown and competition from China. As in other countries, excess capacity in these sectors may need to be shed. While Korean corporates overall appear relatively healthy, there are a number of firms in these particular sectors that are struggling and will need to be restructured.
- *Labor-market issues.* Korea's problem of a declining working-age population is compounded by labor-force participation rates, particularly for females, that are below the OECD average. In addition, the highly segmented labor market is distorted and inefficient—employers' easy access to "non-regular" labor not



only promotes inequality among workers but also leads to under-investment in firm-based training; separately, the heavily seniority-based compensation system leads firms to push older, more skilled workers into early retirement, to the detriment of overall labor productivity.

- *Lagging productivity.* Labor productivity is particularly low in the service sector—much lower than in peer economies, and only half that of manufacturing—reflecting in part regulatory barriers to competition. Productivity is also disappointing among SMEs—just one-third of what it is among large enterprises (and down from one-half in the late 1980s).<sup>2</sup>
- *Insufficient social protection.* Korea has rapidly traversed from emerging- to advanced-economy status and has not yet built a comprehensive social safety net. The Basic Livelihood Security Program (BLSP), introduced in 2000, provides cash and in-kind benefits to the most vulnerable but is substantially less generous than the OECD average. The National Pension System (NPS) currently covers about one-third of the elderly, and pension benefits were only around one-quarter of the average wage in 2015.<sup>3</sup> These inadequacies boost private-sector precautionary savings and depress consumption and growth. They also may have contributed to increasing household debt: many retirees borrow to open (risky) small businesses, in an attempt to supplement their incomes. Total social spending amounts to just 10 percent of GDP, less than half the OECD average, and while population aging will drive this up sharply over the long run, social spending will remain relatively low for the next twenty years, with multiple adverse consequences.
- *Rising household debt.* This represents both a short-term vulnerability, with possible risks to financial stability, and a structural issue, insofar as high debt can depress households' propensity to consume and dampen medium-term growth.

Income inequality and poverty are also issues that are increasingly on the radar screen. Korea's Gini coefficient had fallen to among the lowest

in the world in the mid-1990s and then rose somewhat in the wake of the Asian crisis. While the Gini coefficient remains near the OECD average today, the gap between the richest and poorest quintiles is now slightly higher than average. Moreover, social mobility, traditionally achieved through education and entrepreneurship, is not as strong as in the past—only 20 percent of households were able to move to a higher income bracket between 2011 and 2014, while a similarly sized share slid into a lower bracket. Finally, relative poverty rates, particularly among the elderly, are among the highest in the OECD.<sup>4</sup>

## **The Financial Sector is Overall Sound, but High Household Debt and Pockets of Corporate Weaknesses Create Vulnerabilities**

The financial system remains resilient. Financial soundness indicators—capital adequacy, liquidity, and asset quality of both banks and non-bank financial institutions (NBFIs)—are relatively strong on a point-in-time basis, but they may weaken as banks realize losses on exposures to firms affected by the economic slowdown. Bank credit growth has weakened recently and could slow further given elevated credit risk in the corporate sector. In addition, bank profitability is very low by international standards, possibly on account of banks' policy responsibilities, as well as the low nominal interest rate environment.

Household debt is high. Debt reached 163 percent of net disposable income—above the OECD average of 131 percent. Some key drivers of household debt have been: (1) population aging;<sup>5</sup> (2) a sustained rise in *chonsei* prices;<sup>6</sup> and (3) the recovery in housing prices.<sup>7</sup> Against this background, the authorities announced more stringent bank screening of loan applications, a faster restructuring of the mortgage market toward amortizing and fixed-rate loans, and tighter LTV limits on nonbanks' nonresidential mortgages. The authorities are also planning to introduce comprehensive debt-service ratio (DSR) monitoring for bank borrowers by the end of the year. Following the announcement of these measures, which are under gradual implementation, the growth of household bank mortgages began to moderate—as did house prices—though other household loans continued to grow rapidly.

These measures, though, do not apply to household loans extended by non-bank financial institutions (NBFIs), such as insurance companies,<sup>8</sup> mutual credit cooperatives, savings banks, and securities companies, which accounted for about one-third of the growth in household credit in 2015. In fact, the growth of nonbank household credit has accelerated and may continue doing so as banks' lending standards tighten.

Pockets of vulnerability persist in the corporate sector. Aggregate corporate leverage is moderate, with nearly 90 percent of companies having a debt-to-equity ratio of less than two. But the financial soundness of firms in certain export-oriented industries, as well as construction, has deteriorated as sales have slumped. The share of vulnerable firms—those with an interest-coverage ratio below 1.5—has been high since the global financial crisis and rose beyond 35 percent last year. The authorities have taken steps to foster corporate restructuring and announced plans to recapitalize two major policy banks, Korea EXIM and KDB, that have substantial exposure to vulnerable sectors and could face losses as a result of restructuring.

## **A Modest Recovery from Recent Year Sluggishness is Expected in the Short-term**

With the Korean economy buffeted by the MERS shock and the global trade slowdown, growth dropped to 2.6 percent in 2015, notwithstanding substantial fiscal and monetary stimulus, and remained tepid in the first part of 2016—with some acceleration in Q2.

The weak external environment has weighed heavily on Korea. As in many other regional economies, nominal exports fell sharply during 2015 and early 2016, with the largest declines seen in exports to Asian partners and emerging markets in other regions. Export volumes held up somewhat better but have declined this year. Reflecting Korea's integration in global supply chains, the drop in exports led to a decline in imported parts as well, and given soft domestic demand and low commodity prices, overall imports fell even more sharply than exports did, pushing the current account surplus to a record-high 7¼ percent of GDP in 2015.

Korea experienced portfolio outflows last year and in early 2016—in the aftermath of the RMB tantrum in the summer of 2015, in anticipation of Fed “lift-off,” and, to a lesser extent, following Brexit. However, net portfolio flows seem to have turned positive since June this year. After two years of appreciation, the real effective exchange rate began to weaken, and the authorities appear to have sold foreign-exchange reserves during several months over the past year. Brexit led to initial sharp losses in Korean equities and the value of the *won*, but these were largely reversed in the following weeks.

Reflecting economic slack and low oil prices, inflation has been subdued. Headline CPI inflation dropped, by early 2015, to its lowest levels since mid-1999 and even now remains below one percent, much lower than the Bank of Korea's target, which was recently reduced from a range of 2½ – 3½ percent to 2 percent. Core inflation has been more robust, with some moderation in 2016.

Growth is expected to tick up to 2.7 percent this year and 3.0 percent in 2017, supported by recent monetary and fiscal stimulus and a stronger housing market. On the other hand, export prospects will likely remain difficult. In turn, sluggish exports, together with heightened uncertainty, will weigh on fixed investment. Inflation is projected to remain subdued.

Risks to the near-term growth outlook are on the downside. The main near term external risks include slower growth in Korea's main trading partners (China, U.S., EU) and a re-emergence of global market stress, particularly after Brexit, which could affect capital flows. Domestically, the rebound in private consumption could remain tepid on account of increasing household leverage and weakened confidence following Brexit. Corporate restructuring could lead to higher unemployment and weaken consumption. Besides, corporate restructuring, while essential for the longer term, could have an adverse short-term impact on banks' balance sheets, hampering their ability to extend credit and causing them to tighten lending standards.

## Policies to Boost Potential Growth and Foster Inclusion

With the economy facing major structural headwinds, a comprehensive set of measures are needed in a number of areas, including corporate restructuring, labor market reform, and productivity enhancement. Fiscal policy can play a complementary role, to incentivize these reforms and to cushion their near-term impact. In addition, social safety nets should be strengthened, both to address inequality and poverty, and also to boost consumption-led growth and contribute to rebalancing toward domestic-led (as opposed to export-led) growth. Given long-term fiscal pressures, enhanced social spending would eventually need to be paid for with revenue increases (or cuts in other expenditure), and the authorities could commit to this, and thus ensure debt sustainability, by introducing a set of formal fiscal rules.

### Corporate Restructuring

The authorities have made substantial progress on corporate restructuring. A three-track approach has been devised, covering: (1) shipbuilding and shipping; (2) more routine cases of individual distressed firms across the economy; and (3) the overcapacity sectors of steel, petrochemicals, and construction. Broad plans for Track 1 have already been announced. Moreover, the authorities also announced their intention to further improve policy lending (including the banks' capacity to handle corporate restructuring). In addition, to minimize the impact of corporate restructuring on employment and the regional economy, the government on June 30, 2016 designated the shipbuilding industry as a sector that would require special support. Tracks 2 and 3 may proceed with minimal government involvement, with the latter aided by the recently passed "one-shot" law, which streamlines procedures and offers tax incentives for mergers and acquisitions.

Speedy implementation of corporate restructuring, including not only financial but also operational restructuring of distressed firms, combined with social spending to help affected workers is critical. Resolving the debt overhang could meaningfully boost investment and stimulate hiring. Importantly, the international evidence suggests that corporate restructuring is associated with higher GDP growth afterward, and that swift, decisive action is vital.

Appropriately, the authorities have taken preemptive measures to safeguard the capital position of the policy banks. The recapitalization of these institutions should receive adequate fiscal support as it is the responsibility of the fiscal authorities, although procedural constraints have also implied a short-term role for the BOK in providing bridge financing. The Bank of Korea (BOK) involvement is consistent with its mandate for price and financial stability, but to ensure continued monetary independence and fiscal accountability, the exposure should be unwound—i.e., either repaid from fiscal resources or sold through markets—as soon as possible. Moreover, the government should back up its intention to support an early exit of the BOK by providing sufficient resources for recapitalization in the budget. At the same time, the financial supervisory authorities should continue to monitor commercial banks' exposure to vulnerable sectors, and continue to require banks to maintain sufficient loan loss reserves.

## Labor Market Reforms

The September 2015 Tripartite Agreement between unions, employers and the government contained many important reforms but later lost support from some key actors. A package of labor laws, based on the Tripartite Agreement, is now stalled in the National Assembly. The government remains committed to labor-market reform and has issued policy guidance to employers to promote the "wage-peak" system, emphasize performance-based assessment, and clarify conditions for dismissal.

Going forward, it will be crucial to address market segmentation, which results in youth unemployment, inequality, and insufficient investment in training. A priority is to dampen firms' incentives to hire non-regular workers by fostering cooperative labor relations, expanding benefits for non-regular workers, and reducing labor-market rigidities by introducing performance-based assessment and clear conditions for dismissal. In addition, broadening access to training for non-regular workers will foster productivity.

Boosting female labor force participation is another priority, given the expected decline in the labor input because of aging. Addressing labor market duality will help improve female job participation and increase birth rates, but further measures are also needed—these could include providing well-targeted support for childcare, facilitating flexible work arrangements, improving work-life balance, enhancing job search and training support, and addressing gender-based job inequalities.

### Productivity Enhancement

Boosting productivity in the service sector and among SMEs should be another area of focus. This would require easing the regulatory environment for upstream service sectors (e.g., electricity, gas, and rail), which is very stringent in international comparison. Significant productivity gains can also be achieved by promoting competition and deregulation in healthcare, education, and professional services. As for the SMEs, government policy should prioritize fostering growth and innovation, rather than shielding less competitive firms. Korea is one of the countries most exposed to the rebalancing of China's economy, so it may need to move further up the value chain, develop sectors that benefit from increased consumption in China, and enhance its traded services sectors; as all that happens, the SME sector will also need to respond dynamically.

Against this backdrop, the government recently announced a three-pronged strategy to strengthen the service sector. The plan includes: (1) promoting synergies between services and manufacturing; (2) revamping infrastructure oriented toward services; and (3) nurturing new businesses, notably in healthcare and tourism. To this end, the government will provide greater tax benefits and other financial support and will also embark upon deregulation to promote competition. The overall objective is to ensure that public policy supports both manufacturing and services in an equitable fashion, and the authorities' aim, in this way, to promote the creation of 250,000 new jobs in the service sector, and to increase the sector's share of the economy from 60 percent currently to 65 percent by 2020.

## Complementary Fiscal Policy

Fiscal support should be mobilized to incentivize and cushion any adverse impacts of structural reforms. Additional, well-targeted subsidies for children and for childcare, for instance, could stem declining fertility and improve labor force participation. Fiscal incentives could perhaps be designed to make Korea's substantial R&D activity more effective, complementing the authorities' efforts to promote a "creative economy." And fiscal support, including unemployment insurance benefits, retraining opportunities, and job-search facilities, could assist workers affected by corporate restructuring or labor market reforms—this would allow more equitable outcomes and increase the likelihood of developing consensus for structural reforms.

In addition, a carefully targeted expansion of social expenditure, sustained over the medium term, could yield multiple benefits. Increasing social spending would directly reduce relative poverty among vulnerable groups such as the elderly, nearly half of whom are poor.<sup>9</sup> It could also—by increasing those groups' disposable income and reducing households' need for precautionary savings—boost consumption-led growth and reduce the economy's reliance on volatile external demand. It could contribute to financial stability by reducing retirees' borrowing to open small businesses. And it would give the authorities more room to rationalize support to SMEs, thus boosting labor productivity. There is scope for increases in the basic income as well as the national pension, among other programs. Additional spending to strengthen the public education system would also be desirable.<sup>10</sup>

To preserve sustainability, revenue increases will be needed in the long term to pay for expanded social spending, and fiscal rules could help ensure that these materialize. Increasing revenues too early would, by reducing household disposable income, undercut the desired boost to consumption and growth. But given the long-run fiscal challenges facing Korea, it is clear that compensatory measures will be needed eventually. Increases in social contributions would be a natural place to focus,<sup>11</sup> and tax measures could also be considered—at just 21 percent of GDP, Korea's revenue burden is currently one of the lowest in the OECD. A set of fiscal rules could help make the authorities' commitment to future measures more credible.

## Policies to Provide Short-term Support, Address Vulnerabilities and Rebalance the Economy

Given the weak conjuncture and downside risks, macroeconomic policies should remain supportive. The authorities have already been proactive in their short-term policy responses, recently approving a fiscal stimulus package and cutting the policy rate, both of which were appropriate.

The fiscal stimulus package includes 11 trillion *won* supplementary budget, as well as spending through other channels, such as the SOEs. It features a broad mix of measures including: larger unemployment benefits; economic support, via public infrastructure spending and other measures, of the regions most affected by corporate restructuring; an increased tax deduction for housing rent; and tax incentives for the replacement of old diesel cars and for the purchase of highly energy-efficient home appliances, to name just a few elements. While

the government expects that these measures will largely be paid for by revenue overperformance (and thus will not require additional borrowing), this nonetheless represents discretionary stimulus to the economy. The package should be implemented as soon as possible, and going forward, the macro policy stance should remain supportive.

Monetary policy should also continue to stay supportive. Monetary policy may not by itself provide strong stimulus—it could create negative wealth effects for deposit holders, it could raise *chonsei* prices<sup>12</sup> and thus reduce renters' disposable income, and it will not address structural factors behind weak investment and exports. Nonetheless, a coordinated fiscal and monetary easing stance can send a strong signal and boost confidence.

Macroprudential standards should be tightened to contain risks to household debt. The authorities have responded to the rapid growth of household debt with several measures, but the DTI cap of 60 percent remains high in international comparison and should gradually be tightened toward 30 to 50 percent. The DTI cap should also be extended to apply to other types of household debt (including so-called "group loans").<sup>13</sup>

The recent acceleration in non-bank lending deserves close monitoring, not only because of the risks nonbank credit has posed in other countries (and indeed, in Korea as well, during the past), but also because, in Korea's highly tiered financial system, nonbanks cater to less creditworthy customers and thus face elevated risks. To contain risk, prudential regulations should be harmonized across banks and nonbanks. This includes insurance companies, which engage in direct lending to policyholders but may have limited expertise in assessing credit risk, as well as savings banks and mutual credit cooperatives, which have looser capital requirements than commercial banks, and whose lending is often used by households to finance risky small businesses.

With regard to the institutional framework for prudential policy, separating macroprudential policymaking from crisis management would increase transparency and accountability among the relevant agencies and ensure greater independence.

The authorities are appropriately planning to ease measures aimed at curbing capital inflows that were introduced after the global financial crisis to contain exposure to liquidity and foreign-exchange risk. These included a ceiling on banks' loan-to-deposit ratio, a leverage cap on banks' foreign exchange derivatives positions, and a levy on foreign exchange funding.<sup>14</sup> These measures were successful in increasing financial sector resilience by limiting exposure to liquidity risk, reducing maturity mismatches caused by short-term FX borrowing, and more generally lengthening the maturity of the financial sector's FX borrowing. Now, given that the pressure of capital inflows has declined, the authorities' decision to relax some of these measures is appropriate.

The exchange rate should continue to be allowed to move flexibly, with intervention remaining limited to addressing disorderly market conditions. A flexible exchange rate will help the economy to weather external shocks, a role that can be supported with appropriate macroprudential measures, such as the planned FX liquidity coverage

ratio. Publishing data on intervention, with an appropriate lag, as in most advanced economies, could be also considered.

Many of the policies described above will tend to reduce savings, boost investment, and support growth. Korea's large current account surplus will moderate slowly over time, and the economy will be able to rebalance away from weak and volatile external demand. The exchange rate will need to be flexible to accommodate this transformation, and to help the economy weather external shocks.

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<sup>1</sup> Prepared by Edda Zoli, Senior Economist, International Monetary Fund.

<sup>2</sup> OECD Economic Surveys: Korea 2016.

<sup>3</sup> OECD Economic Surveys: Korea 2016.

<sup>4</sup> OECD Economic Surveys: Korea 2016.

<sup>5</sup> Many of the elderly borrow once retired so as to open small businesses with which to supplement their old-age income.

<sup>6</sup> Under the chonseil rental system, two years of rent are typically paid with an upfront deposit, which is often borrowed from a bank. Landlords have steadily been demanding higher deposits in recent years on account of lower interest rates.

<sup>7</sup> House prices have been rising in the Seoul metropolitan area, while prices in other regions have weakened after increasingly rapidly over the past few years.

<sup>8</sup> Insurance companies in Korea can—unusually, in international comparison—make direct loans to households, including both mortgages and loans collateralized by the value of insurance policies.

<sup>9</sup> OECD Economic Surveys: Korea 2016.

<sup>10</sup> Improving the quality of schools and access to public afterschool tutoring would reduce Korean households' private spending on education, which, at 38 total spending, is nearly double the OECD average.

<sup>11</sup> In this context, a faster pace of increases in the retirement age could also be considered. Automatic adjustment mechanisms could also be envisaged, whereby the authorities would commit to introducing a particular revenue measure if the debt, or the deficit, breached a certain threshold.

<sup>12</sup> Landlords tend to ask for increased chonseil deposits when rates fall in order to keep their interest income up.

<sup>13</sup> These are taken by a group of prospective apartment buyers and guaranteed by developers and public credit guarantee corporations.

<sup>14</sup> The application of the macroprudential stability levy was expanded to NBFIs in 2015, while the application to short-term FX borrowing was narrowed.