

Korea's Economy: Decent Short-run Outlook but Long-run Challenges

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Real growth in 2006, at 5 percent, did not fully measure up to the more optimistic forecasts of a year ago but did represent a further recovery from the slump encountered a few years earlier. Forecasts for 2007 center on a decline in growth to 4.5 percent, as the year began on a weak note. Policy officials' short-run concerns are directed at the possibility of further *won* appreciation and the state of the housing market. Dealing with longer-run challenges—the low birthrate, Korea's role amid the rising economies of China and India, and the potentially staggering burden of unification of the two Koreas—is a more difficult task.

2006 Results

According to preliminary data, 2006 was a good but not spectacular year. Thanks to strong performance in the latter part of 2005 and continued momentum in 2006, growth for the full year was 5 percent, representing the best result since 2002. Export performance continued to exceed expectations, despite further strengthening of the *won*. However, domestic demand was the principal factor—its share in total growth increased for the fourth consecutive year, as private consumption and facility investment both significantly exceeded results in prior years.

- Exports of goods (national accounts basis) rose 13 percent, up from 9.7 percent in 2005. In nominal terms, on a customs basis, exports totaled \$326 billion, the fourth consecutive year of double-digit growth; annualized average growth during this period was 19.3 percent, the second highest growth rate among the top 11 trading nations, according to the Korea International Trade Association. The robust export performance has been led by high-tech products and other products distinguished by non-price factors, as well as construction and machine goods aimed particularly at emerging markets such as China and India.
- Imports also continued to rise steadily, reaching \$309 billion and moving Korea into 12th place among the world's largest importers. Import growth between 2002 and 2006 averaged 19.4 percent annually.
- While net exports accounted for nearly one third of the 5 percent real GDP growth in 2006, domestic demand accounted for the lion's share. This contrasts sharply with 2003 and 2004, when net exports accounted for over half of total growth, and 2005 when they accounted for nearly half.
- Although growth of private consumption, which constitutes more than half of GDP, slowed in the second half of 2006, its momentum enabled it to account for nearly 40 percent of total growth. The recovery of private consumption from the bursting of the "household debt bubble" in 2002 has, in essence, largely been completed, so that future growth will depend more on income and less on restoration of household balance sheets.
- Facility investment was the fastest growing component of expenditure in 2006, rising 7.5 percent. This was the second consecutive year of strong performance, following several years of weak investment activity.
- Korea's current account surplus declined from \$15 billion in 2005 to \$6-1/2 billion in 2006. The principal features were a substantial widening of the deficit on trade in services, to a record \$18.8 billion, and a moderately narrower surplus on trade in goods of \$29.2 billion. Koreans' spending overseas for travel, study, and training increased by 18.4 percent to over \$18 billion.

2007 Outlook

Official and private forecasts are largely in agreement about the outlook for the economy in 2007. The consensus is roughly for real growth to be around 4-1/2 percent, with a mild slowdown in the first half being partly offset by recovery in the second half.

In a preliminary version of its Economic Policy Direction for 2007, released in mid-February, the government projected growth around 4.5 percent. It expects growth of private consumption to slow a bit, to about 4 percent, in light of “unsatisfactory” trends in employment and household income, while both facility investment and construction post solid gains. Exports are seen as growing soundly albeit a little more slowly. The current account surplus is seen as narrowing to near zero, largely as a result of a further widening of the deficit on services trade.

Assorted weak data releases at the end of 2006 and beginning of 2007 are presumably behind the expectations of a relatively soft first half. Industrial production (seasonally adjusted) declined in November and December. Consumer sentiment indices softened in the latter part of 2006, and business sentiment indices were sharply lower in January. Retail sales at large stores fell sharply in January, although the timing of the Lunar New Year holiday and the warm weather may have been largely responsible. However, industrial production recovered smartly in January.

Risks and Challenges Ahead

The most mentioned potential downside risks to short-term growth are related to housing, exports, and investment.

- While most analysts do not see a generalized bubble in housing prices, the rapid rise in recent years, at least in some regions, increases the scope for at least a temporary reversal, which could weigh heavily on already moderating private consumption.
- Although exports have appeared nearly immune to the significant appreciation of the *won* in recent years, there are signs that it is becoming a significant factor. According to press reports, the head of Korea research at Morgan Stanley said in mid-February that the *won* is overvalued by 11 percent and that “Korea’s export prices are rising faster than (those of) its major competitors.”
- Some analysts see the recent strong growth of investment as likely to be temporary. A recent analysis by the Samsung Economic Research Institute cites reduced demand in mature consumer markets; the adverse impact on corporate profits of the strong *won*; and social and political instability related to concerns over the housing market, the forthcoming presidential election, and the potential for a flare-up of the North Korea nuclear issue.

Longer Run Challenges

Concerns about near-term risks to growth pale in comparison to the longer-term economic challenges faced by South Korea. The most visible challenge is the demographic one, as the prospect of a rapidly aging society requires policy adjustments to ensure viable pension and health systems, and a flexible source of labor.

Less predictable is the impact of the rise of China and India, requiring Korea to move further up the technology ladder and find its comparative advantage. The standard advice of economists is to allow market forces to work more efficiently by increasing transparency, improving corporate governance, and pursuing deregulation—all objectives that the government endorses in principle but on which much remains to be done.

Least predictable is the impact of eventual unification with North Korea. Not only is the timing of this event at best a matter of speculation, the manner in which it is carried out will be decisive in determining the burden on the South Korean economy.