KOREA'S ECONOMY

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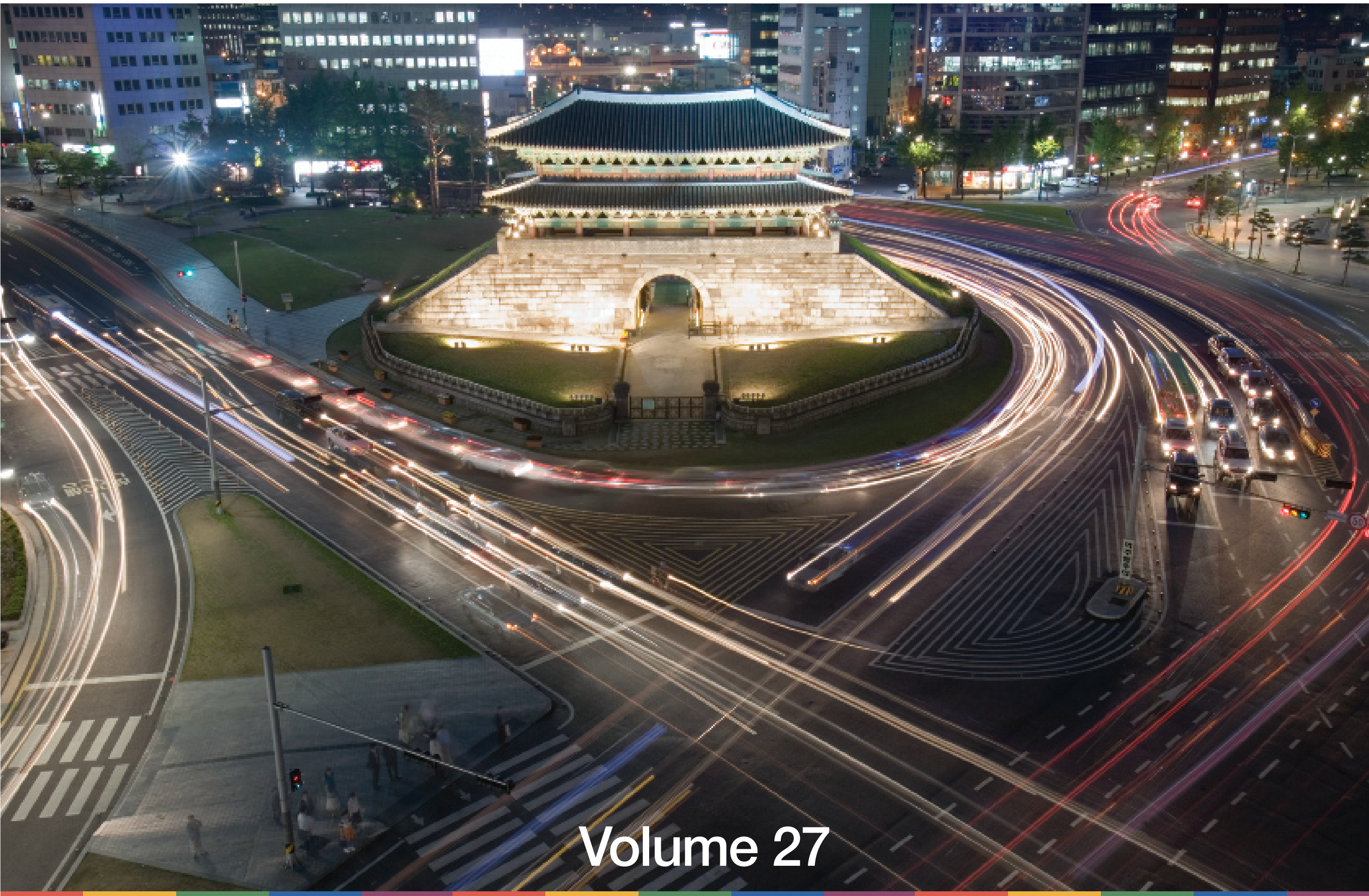

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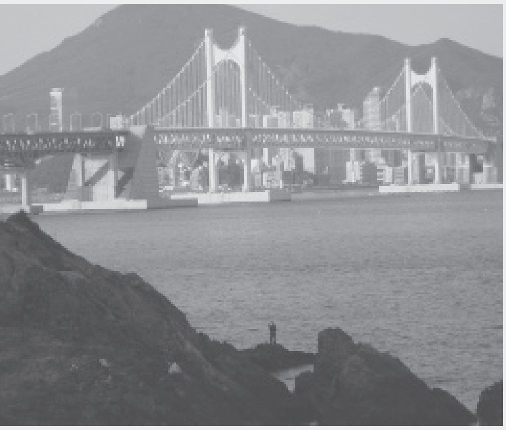

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KOREA: ECONOMIC PROSPECTS AND CHALLENGES AFTER THE GLOBAL RECESSION

By Subir Lall and Meral Karasulu

Korea's V-shaped recovery from the Great Recession that began in early 2009 was among the fastest in the world and gave way to a robust expansion in 2010 that is now in full swing. This impressive growth was initially driven by supportive macroeconomic and financial policies and normalization of global trade, but has become increasingly more self-sustaining during 2010 with a robust recovery in private domestic demand. In the last quarter of 2010, exports began to accelerate again, after the moderation from the exceptionally fast postcrisis rebound, helped by the consolidation of recovery in advanced economies as well as by the brisk pace of intraregional trade.

As a result of these developments, IMF staff estimate that Korea's output gap, that is, the difference between actual and potential economic output, has closed in the second half of 2010, and since then the pace of expansion has been proceeding somewhat above the economy's underlying potential. Consequently, excess domestic demand pressures have led to rising inflation pressures. The sharp increase in global commodity prices as well as the outbreak of foot-and-mouth disease in Korea have added to the demand-driven price pressures, leading CPI inflation to remain above the Bank of Korea's (BOK) target band for three consecutive months in 2011 so far.

With solid economic prospects for the remainder of the year, the main short-term policy challenge now is to ensure a soft landing to a sustainable medium-term growth path and contain inflation pressures. There is also a need to address the medium-term policy challenges to enhance the resilience of the Korean economy and pave the way for sustained and inclusive growth over the medium-term.

The remainder of this paper is organized as follows. The first section focuses on economic developments in 2010 and early 2011, the outlook for the remainder of the year, and risks to the outlook. The second section discusses both the macroeconomic policy challenges in the near term to ensure a smooth transition from expansion to sustainable medium-term growth and medium-term challenges focusing on structural policies and policy frameworks to strengthen economic resilience.

Moving from Recovery to Expansion

Korea's openness to global trade and financial flows led to the sharp contraction in growth at the end of 2008 but also paved the way for Korea's rapid recovery since the first quarter of 2009, buttressed by the normalization of global trade and the downward flexibility of the Korean *won* exchange rate. Against this background, the combination of timely and aggressive policy measures and healthy balance sheets of banks and large corporates helped stabilize economic activity and financial market conditions rapidly.[1]

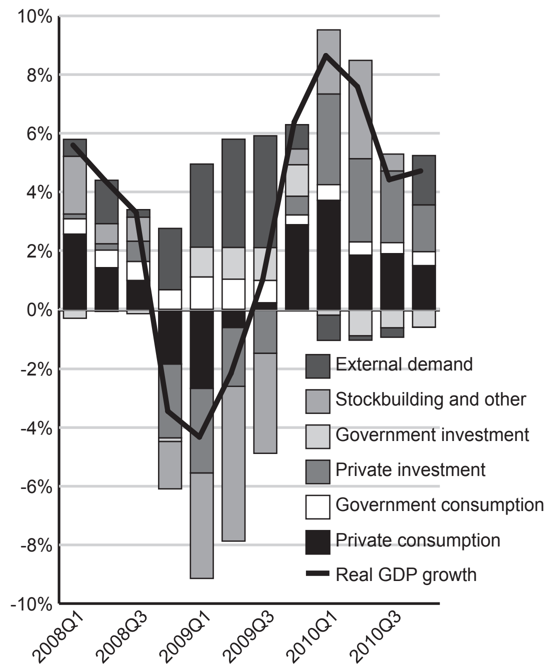
Since the second half of 2009, the recovery has broadened to domestic private-sector sources of demand (***Figure 1***). With the turning of the global inventory cycle and robust private facilities investment that ensued, labor markets normalized by early 2010, providing a strong rebound to private consumption. As a result GDP growth rebounded to 6.2 percent in 2010.

Ample global liquidity and weaker growth prospects in advanced economies continued to fuel capital inflows to Korea, but at a much lower speed than in 2009 (***Figure 2***). In 2010 total net inflows declined to about $2 billion despite robust net portfolio inflows, as bank borrowing from abroad declined in part due to the set of macroprudential measures introduced beginning in November 2009. Nonetheless, foreign exchange

1. See "Republic of Korea: Staff Report for the 2010 Article IV Consultation," IMF Country Report no. 10/270 (Washington, D.C.: International Monetary Fund, September 2010), www.imf.org/external/pubs/ft/scr/2010/cr10270.pdf.

reserves were replenished to above precrisis highs, and the Korean *won* remained about 12 percent below its mid-2008 level in nominal effective terms.

Figure 1: **Contributions to GDP Growth in Korea, 2008–10**

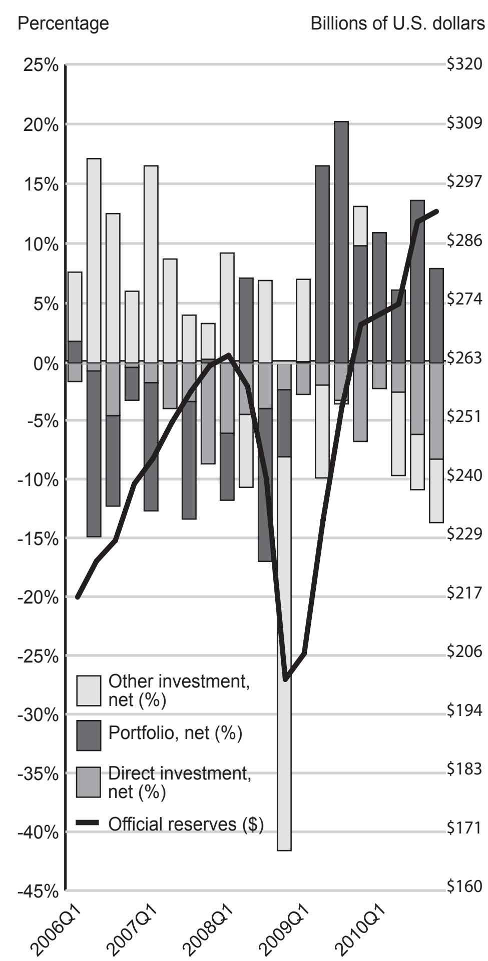


Source: CEI Data Company Ltd.

Financial markets also recovered from their lows of the crisis. The Korean stock market index, KOSPI, returned to its precrisis level by mid-2010, aided by ample global liquidity and strong earnings prospects of Korean corporates in line with the recovery. The banking system continued to increase its resilience by bolstering capital in 2010 (***Figure 3***) despite substantial write-offs of nonperforming loans, especially emanating from the construction sector. Nonetheless, credit growth remained subdued, partly owing to lower demand from both small- and medium-size enterprises (SMEs) and households but also owing to generally tighter regulatory requirements on commercial banks, including on mortgage lending and noncore funding limits.

In recognition of the vulnerability of the Korean banking system to abrupt shifts in global funding conditions,[2] the Korean government implemented a series of macroprudential measures after November 2009 that zeroed in on these vulnerabilities. Stronger foreign currency liquidity standards were introduced to reduce the maturity mismatch of banks' foreign currency assets and liabilities and to improve the quality of their liquid assets, and a cap on forward foreign exchange contracts (relative to underlying export revenues) was imposed between banks and exporters, which was

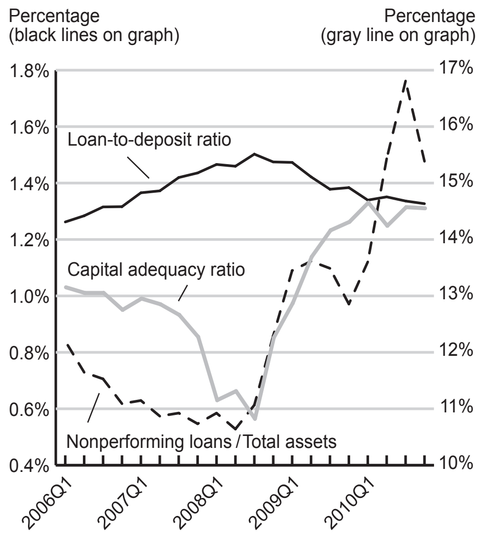
Figure 2: **Capital and Financial Account in Korea, 2006–10**



Sources: CEI Data Company Ltd.; Bank of Korea; IMF staff calculations.

2. Between September and December 2008, $50 billion of funding to domestic banks left the country as foreign bank branches in Korea, facing liquidity pressures in global markets, diverted funds back to their headquarters.

Figure 3: **Banking Indicators in Korea, 2006–10**



Source: Financial Supervisory Service, Government of Republic of Korea.

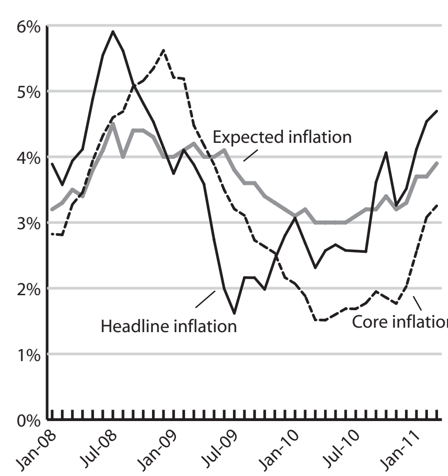
set at 125 percent initially and then reduced to 100 percent. In June 2010, the authorities also introduced ceilings on foreign derivatives positions of banks as a ratio to their capital to reduce the short-term external debt that resulted from banks' provision of forward contracts to corporates. The objective was to reduce the leverage of banks and to guard against the abrupt withdrawal of capital, especially by foreign banks. To address reliance on domestic wholesale funding, banks were also directed keep their loan-to-deposit ratio below 100 percent. Banks would therefore have little incentive to borrow from the wholesale funding market as they would not be able to increase their lending to households or corporates beyond what they collect in deposits.

With a strong economic recovery under way, the macroeconomic policy mix in 2010 comprised a combination of withdrawal of the large fiscal stimulus extended in 2009 as well as a gradual normalization of the crisis-driven accommodative monetary policy stance. Although this combination of policies helped deliver robust growth in 2010, it also led to aggregate demand pressures. Korea's output gap is estimated to have closed in the second half of 2010, and since then growth has been above potential, thus leading to excess demand pressures on inflation. Sharply rising global commodity prices since the end of 2010 as well as the outbreak of foot-and-mouth disease in Korea have also added to price pressures and have resulted in CPI inflation remaining above the BOK's 2–4 percent target band for the first three months in 2011 (***Figure 4***). Core inflation—inflation excluding the volatile food and fuel components—has also begun to rise, and consumer surveys and bond markets also point to higher inflation expectations in the period ahead.

Outlook and Risks Going Forward

Going forward, IMF staff estimate that GDP growth in 2011 will stabilize at around 4.5 percent, and inflation is expected to average 4.5 percent on current trends. The risks to this outlook are balanced, coming mainly from the external environment and reflecting Korea's high dependence on exports. The prospects for more enduring global growth have increased, driven by an improved outlook for investment and consumption in advanced as well as in emerging economies. Although this is an upside risk for Korean exports, continued strong global demand could result in persistently high food and fuel prices, which already are passing through to core inflation. In addition, should the recent surge in oil prices persist, this could slow the global demand for Korean exports and, hence, Korea's growth. At the same time, significant vulnerabilities still remain in advanced economies, and especially in Europe, in both

Figure 4: **CPI Inflation in Korea, January 2008–March 2011**



Source: CEIC Data Company Ltd.

the financial and fiscal spheres. These could threaten the global recovery and spill over to Korea. In particular, risks related to sovereign and banking sectors in the euro area could drastically alter risk perceptions and further increase the volatility of capital flows to Korea. This could hurt private domestic demand in Korea by lowering consumer and business confidence and increasing financial risk premia. The tragic events in Japan, however, are not expected to pose an enduring risk to growth in Korea assuming that the the regional supply chain is not unduly disrupted.

Near-Term Macroeconomic Policy Challenges

With a rapid and self-sustaining economic expansion under way and increasing inflation pressures, macroeconomic policy settings need to adjust accordingly. This process has already begun, and now the policies need to focus to ensure a soft landing from expansion to a sustainable medium-term growth path.

Fiscal policies are already at an advanced stage of withdrawal of the stimulus extended in 2009. In 2010 fiscal policy normalization subtracted 2 percent from growth, and the 2011 budget is estimated to be broadly neutral. This should set the stage for consolidation going forward to address medium-term fiscal challenges.

The BOK also initiated the process of gradually normalizing accommodative monetary conditions. Since June 2010 it has raised the policy rate four times, from a historic low of 2 percent in February 2009 to 3 percent by March 2010. Nonetheless, the speed of this normalization still leaves real interest rates, that is, interest rates after subtracting inflation, in negative territory. Furthermore, according to IMF staff estimates, the Korean *won* remains weaker than its fundamentally driven value by about 5–10 percent, contributing to overly accommodative monetary conditions for this stage of the expansion. This configuration of events bears some resemblance to the previous high-inflation episode in Korea (and many other countries) during 2007–08. Back then, despite a large and rising output gap and rising food and fuel prices, monetary policy was unable to keep the real policy rate from declining, although it remained positive. Were it not for the global financial crisis and the ensuing Great Recession, inflation in Korea would have risen beyond its 2008 peak of 5.9 percent.

In recognition of the rising inflation pressures, the Korean government has appropriately made controlling inflation its top policy priority. A set of administrative measures was announced in January 2011, which primarily target subduing price pressures of agricultural and petroleum products and public utilities and tuitions through temporary reduction in custom tariffs and tax incentives; in addition, longer-term measures were put in place and aimed at easing supply-side bottlenecks in agricultural product distribution. Although administrative measures that target market inefficiencies are desirable, they are not substitutes for an appropriately tighter monetary policy stance against supply-side inflationary pressures. Other administrative measures that create an artificial wedge between the cost and market price would have quasi-fiscal costs for the government and may be effective only in the short run and may impede supply if sustained.

Given the stage of expansion, monetary policy still is the most important tool for containing rising inflation expectations, which will need to respond even more decisively now to reduce inflation to within the target range of the BOK and avoid a hard landing. A flexible exchange rate would also be a key component of the policy response to the overheating pressures.

Medium-Term Challenges: Policies for the 21st Century

The medium-term challenges of Korea are widely known;[3] a fast-aging population with associated fiscal costs and growth implications looms large on the horizon, while the overreliance on the tradable sector as the main driver of growth exposes the economy to vulnerabilities from shocks elsewhere in the world, as seen during the Great Recession. However, the available fiscal space and the currently low public debt—especially compared with many advanced economies—and the short-term benefits from export-driven growth may by themselves lead to the postponement of more decisive actions to boost longer-term sustainable growth and resilience.

3. Subir Lall, "Korea's Economic Prospects and Challenges," *Korea's Economy 2010* 26 (2010): 1–7.

One example of fragilities that arise in part because of the export-oriented focus of the economy is the high indebtedness of households and SMEs. This long-standing problem[4] is closely linked to the relative weaknesses in the nontradable sector and the dualities in the labor market and would require a more fundamental policy response. Furthermore, macroeconomic policy space may be constrained going forward if underlying problems are not addressed. For instance, monetary-policy makers may be more constrained in their interest rate decisions as fragilities in household balance sheets become widespread, and the government could be hard-pressed to assume further quasi-fiscal liabilities[5] through direct support to SMEs and the construction sector.

Another example of potential fragilities linked to medium-term challenges is the vulnerability to a sudden stop, as experienced in 1997 and 2008. Despite Korea's strong macroeconomic position and a healthy financial sector, outflows in 2008 were among the largest in the world, with international reserves falling by $64 billion and the stock market index losing in just a few months more than 70 percent of its value relative to its precrisis high. With strong inflows returning in 2009 and 2010, the concern has shifted to potential buildup of excessive leverage in the financial sector as well as potential impact of these flows on asset prices. The macroprudential policy response appropriately focused on addressing immediate potential financial vulnerabilities associated with these inflows and lessons learned from the sudden stop during the height of the crisis. These measures were successful in reducing short-term debt of Korean banks and their reliance on wholesale funding. However, they are unlikely to change the volatility of flows to Korea, with its heavy external dependence and ambitions to become a financial center with liquid and open capital markets. In the same vein, the recent reimposition of a withholding tax on nonresident purchases of local currency bonds and the prospective introduction of a macroprudential stability levy on financial system borrowing from abroad will likely have only a marginal impact on inflows and their volatility.

The above examples underscore the need to rethink the nexus of policymaking in the aftermath of the Great Recession in order to address risks to financial and macroeconomic stability as well as medium-term sustainability that can emerge through the interaction of real and financial sectors overlaid on structural challenges.

Thus, addressing Korea's medium-term challenges should start with a full-fledged medium-term structural policy agenda to rebalance the economy away from heavy reliance on exports toward the nontradable sector. The Korean government has already started this process through its commitments under the Group of 20 (G-20) Mutual Assessment Process; however, bolder reforms will be needed to help set the next stage for Korea's impressive economic history in the 21st century.

Key elements of this medium-term agenda should include a reassessment of tax and other incentive policies that favor manufacturing exports over the nontradable sector. Of course Korea's comparative advantage as a leading manufacturing exporter will continue serving the country well for some time; however, creating employment opportunities for future generations will need to depend increasingly on the prospects of the services sector and addressing the dualities in the labor market. This is especially relevant in light of the rapid aging of the population, which should have implications for both labor demand and labor supply, as health care and demand for other services will increase while labor supply is projected to start shrinking starting in less than a decade.

Currently, the formal labor sector (or regular employment) is in large part related to manufacturing exports, whereas the SME sector, which accounts for the majority of employment and about 80 percent of the

4. See Meral Karasulu, "Local Challenges in Global Korea: Rebalancing with Leverage," *Korea and the World Economy* 11, no. 3 (December 2010) for a discussion of its origins.

5. The debt of the government-owned Korea Land and Housing Corporation, the agency involved in these support measures, was about 10 percent of GDP at end-2009, more than half of all construction sector debt.

output of the services sector, relies more on irregular workers. This labor market duality is a reflection of the structural weaknesses in the nontradable sector and is a key factor behind increasing income inequality. Addressing this disparity would require both reforms in the labor market to reduce employment protection for regular workers and expand social protection for nonregular workers as well as policies that increase productivity and employment opportunities in the nontradables sector. These should include increasing competition in the services sector, equalizing tax treatment between the manufacturing and services sector by reducing the preferential tax treatment of manufacturers, and dealing with the high degree of leverage in many SMEs.

"As one of the most dynamic economies of the world, Korea is well placed to take up these challenges and lead its peers in upgrading its policymaking framework consistent with the new realities of the global economy."

Against the background of these structural challenges, there is also a need to reassess macroeconomic policy frameworks to ensure that their shorter-term vision does not distract from addressing these structural challenges while cushioning the economy from the effects of shocks it may face. For instance, the Great Recession underscored the importance of having room to conduct countercyclical fiscal policy, as demonstrated effectively by Korea. Past fiscal prudence ensured that Korea had one of the lowest government debt levels in the G-20 and hence could afford fiscal stimulus larger than the G-20 average. This fiscal prudence should now shift to addressing looming long-term pressures such as the impact of the aging population on the pension system and health care expenditures. The Korean government is, therefore, targeting a balanced central government budget (excluding social security funds) by 2013–14 as part of it fiscal consolidation plan, which is already well advanced.

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 health care reform, broadening of the tax base, improved tax administration, and some reallocation of public expenditures. In addition, measures to increase labor market participation of women, the old, and the young would also help.

As one of the most dynamic economies of the world, Korea is well placed to take up these challenges and lead its peers in upgrading its policymaking framework consistent with the new realities of the global economy. This would set the stage for another stellar episode in Korea's economic history.

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