THE POLITICAL ECONOMY OF SOUTH KOREA UNDER THE NEW INTERNATIONAL ORDER

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Abstract

The political economy in South Korea changed immensely through a series of internal and external events in 2011 and 2012. At the same time, actual economic performance was disappointing and far less than the 7 percent that President Lee Myung-bak had envisioned. The economic picture also worsened for households and businesses as households saw consumer prices rise by 4 percent, while businesses faced increasingly higher prices for oil. At the same time, household debt surpassed 900 trillion *won* and all of the indicators of income inequality worsened. The National Assembly elections saw both political parties push for increased welfare spending. However, the proposals put forward by both parties may not be feasible due to constraints on the government's total budget. With the global economic condition, continued fiscal troubles in Europe, and a slowdown of economic growth in China, Korea also faces reduced expectations for economic growth in the year ahead.

Introduction

In 2011, the landscape of the political economy in South Korea changed immensely through a series of internal and external events. The earthquake and its aftermath in Japan and the fiscal crisis in Europe were two external events, while the new political syndrome after the election of a new progressive mayor in Seoul and the sudden death of Kim Jong-il were two remarkable events within the Korean peninsula. In early 2012, U.S.-North Korea bilateral talks were initiated by President Obama and North Korea's new leader Kim Jong-un, with an accord made on February 29 to limit North Korea's nuclear activities. But on April 14, less than six weeks after the accord was signed, the new North Korean regime launched a long-range missile equipped with a satellite without regard for a U.N. resolution and paying no heed to the United States and even to its biggest patron, China.

The timing of the missile launch was deliberately chosen to inaugurate Kim Il Sung's 100th birthday on April 15; to celebrate the appointment of Kim Jong-un as the First Secretary of the ruling Workers' Party, the de facto leader of the regime at a special conference on April 11; and to disturb general elections in South Korea on the same day. But the missile launch failed in the early morning of April 14, and there is wide-spread speculation this failure would increase the likelihood of a follow-up nuclear detonation as a face-saving effort. South Korea must face the new realities of this international political order. Instability in the North Korea regime as demonstrated by the failed missile-launch may signal violent confrontation ahead.

In South Korea, the governing New Frontier Party has won the general election with a narrow margin (152 seats) against the opposition coalition of Democratic United Party (127 seats) and United Progressive Party (13 seats). When independent winners are included, the number of conservatives (158 seats) is slightly larger than the number of progressives (142 seats). The opposition coalition gained many more seats in this general election than the previous one in 2008 which was held just after the inauguration of President Lee Myung-bak. The Lee government lost popularity, particularly among younger generations and voters in the Seoul metropolitan area. While the government has claimed that South Korea has escaped from the global financial crisis of 2007-2008 with relatively better recovery than most other nations, public sentiment has been against the claim.

Macroeconomic Performance During 2008-2011

The actual economic performance (3.1 percent average growth of real GDP and 0.45 percent average growth of real investment) during 2008-2011 has been disappointing and far less than the campaign vision of 7 percent real GDP growth. The only bright side of the economic performance was a strong export performance. The f.o.b.-based export amount increased at the average annual rate of 11.7 percent while the c.i.f.-based import amount increased by 12.8 percent. It was largely due to the depreciation of *won* from 938.2 *won* per dollar at the end of 1997 to 1,257 *won* per dollar at the end of 2008 after the global financial crisis and to 1,153 *won* per dollar at the end of 2011. The OECD Economic Surveys (2010)[1] state that the sharp depreciation of the *won* helped to trigger Korea's rebound by significantly improving its international competitiveness, and thus raising Korea from the world's 12th largest exporter in 2008 to ninth in 2009. In summary, the average GDP growth rate of 3.1 percent during the last four years of the Lee government was maintained by export performance through the depreciation of *won* against the dollar and *yen*. But the extra export earnings were not fully channeled to the non-exporting sectors and therefore, the growth of GNI after being adjusted by unfavorable terms of trade effects through increased oil prices remained stagnant. One of the reasons is the concentration of high export performance in a few IT-related products. During the period of 2000-2009, higher IT-intensity manufactures' real exports have increased at the annual rate of 10.06 percent while lower IT-intensity manufactures' real exports increased at the annual rate of 4.09 percent. During the same period, the annual growth rates of real GDP in two sectors were 5.10 percent and 3.78 percent respectively, which implies that export-output ratio was much larger in higher IT-intensity sectors than in lower IT-intensity sectors.

According to 2011 National Accounts (preliminary) released on March 30, 2012 by the Bank of Korea, 2011 was a disappointing year for both businesses and households. The per capita Gross National Income (GNI) in 2011 was estimated to be $22,489, which is only a 1.5 percent increase due to the worsening terms of trade by increased oil prices and CPI (4.0 percent) and reduced semiconductor prices. The net savings rate by households continued to decline from 4.1 percent in 2009 to 3.9 percent in 2010 and 2.7 percent in 2011. Gross fixed capital formation declined by 1.1 percent from 2010 with construction investment (-5.0 percent) and equipment investment (3.7 percent), which recorded a drastic decline from 2010 (25.7 percent). The growth rate of real GDP in 2011 was 3.6 percent with manufacturing (7.2 percent), construction (-4.6 percent) and services (2.6 percent).

While the Consumer Price Index (CPI) increased by 4.0 percent last year, the price of agriculture, fishery and cattle increased by 9.2 percent. As a consequence, the Engel coefficient which measures the proportion of household expenditure on food and non-alcoholic beverages in total household expenditure, increased from 13.8 percent in 2010 to 14.6 percent in 2011 according to the National Statistical Office of Korea. The Engel coefficient of the first docile (the lowest 10 percent income group) increased from 22.5 percent to 23.5 percent which is a record high and ten percentage points above the average Engel coefficient for the entire household.

Household Debt Overhang and Growth with Inequality

The Bank of Korea announced that total household debt had surpassed 900 trillion *won* by the end of 2011, which reached beyond 70 percent of nominal GDP and 160 percent of total wages and salaries. The switch of commercial loans from the indebted corporate sector to the mortgage-backed household sector by both the primary and secondary banking sectors after the financial crisis of 1997-1998 has been the main cause of the households' debt overhang. Fueled by the low interest rate policy by the government, the real estate market had a boom and a bust during the last decade. The government introduced a set of regulations on real estate loans in order to curb housing inflation and many households are squeezed by inactive real estate transactions and mortgage-backed household loans. According to a report by the Seoul Policy Development Institute, the household debt of Seoul residents is estimated at about 204 trillion *won* and about 60 percent of Seoul households are currently indebted. The ratio of household debt was lower (58.0 percent) when annual household income was above 60 million *won*, compared to household income of 20-30 million *won* (65.4 percent).

According to the National Statistical Office's report on Household Expenditure Survey in 2011, all of the indicators of income inequality have worsened. The relative poverty ratio, which is defined as the ratio of households including one-man households and farm households whose income is less than 50 percent of the median household income, has increased from 14.9 percent in 2010 to 15.2 percent in 2011. The decile distribution ratio, which is defined as the ratio of the top 20 percent income to lowest 20 percent income, has increased from 5.66 to 5.73. In terms of market income, the ratio reached its highest level of 7.86 since this statistic first was complied in 2006. The Gini coefficient has also slightly deteriorated from 0.310 to 0.311. However, the report points out some mixed evidence on income inequality by non-farm households with two-persons and above. The monthly household income in 2011 reached 3,842,000 *won* which increased by 5.8 percent from 2010. But because of a high inflation rate (4.1 percent), the real average monthly income only increased by 1.7 percent. On the other hand, the average monthly consumption expenditure was 2,393,000 *won*, an increase of 4.6 percent from 2010 but only by 0.5 percent in real terms which indicates very little incremental real consumption.

A recent study by OECD (2011) reveals that income inequality among elderly citizens (age 65 and older) in South Korea is the third highest among major economies and that the country's pension system remains relatively insufficient to support retirees. The Gini coefficient for those aged 65 and older in Korea is 0.409: lower than Mexico (0.524) and Chile (0.474) but higher than the U.S. (0.386), Japan (0.348), France (0.291), Germany (0.284) and the Czech Republic (0.188). The Gini coefficient for the age group 18 to 65 in Korea is estimated to be 0.300 lower than most of countries: Chile (0.496), Mexico (0.469), Turkey (0.403), U.S. (0.370), Israel (0.359), Portugal (0.347), Australia (0.324) and Japan (0.323). The large gap in the Gini coefficients between Korea's working generation and senior citizens indicates that there is lack of post-retirement pension fund and therefore, there is a major welfare problem. It reflects that parents of the baby boom generation spent too much money on their children's education, and saved too little money for their own retirement.

Welfare Expenditure Spree and Vision

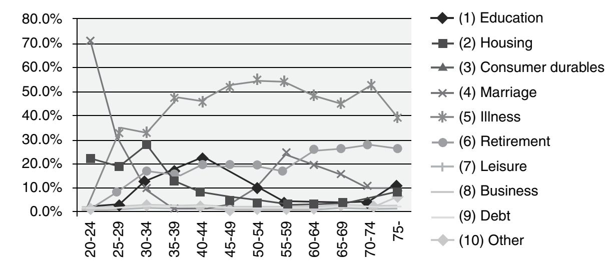
The welfare expenditure level in 2007, just prior to the Lee government, was about 61.4 trillion *won* which accounted for 25.9 percent of total government expenditure. However, welfare expenditure in 2012 will increase to 92.6 trillion *won*—28.5 percent of total government expenditures. The government's third Welfare Task Force forecasts a total minimum of 268 trillion *won* (53.6 trillion *won* per year) will be required to fulfill welfare visions made by both the ruling party and the opposition party before the general election. Since the total government budget in 2012 is 325.4 trillion *won* and the welfare budget in 2012 is 92.6 trillion *won*, the next government would need about 82.4 percent of the total budget in 2012 over the next five-year period. It also implies that the total government budget and the welfare budget need to be increased by 16.5 percent and 57.9 percent respectively, which makes the welfare vision simply unfeasible. The Korea Institute of Public Finance's report on the impact of aging and population reduction on public finance forecasts that the government debt would reach 102 percent of GDP by 2050 even without such a welfare budget increase. The only options available to the incoming government would be to increase welfare taxes or to issue government bonds but both of these options would undermine the economy's long-term potential and increase the likelihood of a euro zone type fiscal crisis in the future.

In a recent report published by the National Pension Research Institute (Pyo, Kim and Lee 2012)[2], we analyzed the national pension system in Korea which was introduced in 1998 and now has over 18 million subscribers. South Korea has become one of the fastest aging nations among OECD countries. The proportion of population age 65 and above was 11.0 percent in 2010, but is estimated to reach 38.2 percent by 2050. During the same period, the elderly dependency ratio which is defined by the age 65 and above population divided by the age 15 to 64 population, is estimated to increase from 15 percent to 72 percent by almost five times. The revised National Pension Act of 2007 stipulates a target to reduce the income substitution ratio by half a percentage point from 50 percent in 2008 to reach 40 percent by 2028. We have recommended three policy options to make the national pension plan self-sustainable: (1) reduce income substitution ratio even after 2028; (2) increase the national pension tax rate and; (3) the government subsidy. Since other social safety net programs are strong—childcare, education and poverty reduction—none of these three options seems politically feasible. However, the only way of ensuring feasible welfare programs in a fast aging society is to increase welfare-related taxes or reduce the coverage and benefits of diverse welfare measures. Another consideration in many discussions is the contingency welfare plan when unification with North Korea occurs. Even though the current welfare standard (welfare expenditure/GDP ratio) of South Korea is relatively low among OECD nations, the speed of aging in South Korea and the potential burden of the contingent unification require more prudent welfare policies in the times ahead. Marcus Noland stated that "standard models of the costs of unification suggest that the amount of investment needed to raise North Korean per capita incomes to 60 percent of the South Korean level, are in excess of $1 trillion, or roughly equal to South Korea's annual national income."[3] Regardless of the estimates, no doubt the cost of reunification will be huge, and South Korea will be unable to absorb the economic cost itself.[4]

Saving Rates and Motives in Korea

I have examined the motives of household savings from the data of Korea Labor Income Panel Study (KLIPS) (1998-2008) in a recent paper (Pyo, 2012).[5] I have found that retirement, education and medical concerns due to illness, are the most significant motives for savings throughout all age groups (See Table 1 and Figure 1). The concern for illness and therefore savings motivation for medical expenses are the largest for those in their 40s and 50s and reflects a precautionary motive. Saving for education was strong during the 30s and 40s. On the other hand, the savings motivation for retirement came on strong rather late, age 60 and above, for household heads.

Figure 1 Proportion of Households Saving for Selected Motives by Age Group of Household Head



Sources: KLIPS Data

This survey data indicates that the high burden of education costs fell on those in their 30s and 40s, which in turn has made them less prepared for their own retirement: the over-investment in education and under-investment in retirement. The high medical cost sits in the middle, inducing households to save little for their retirement. When I estimated returns to schooling and examined the savings rate and motives of households, I found that there is a likelihood of over-investment in education and under-investment in retirement, causing a welfare-related social issue. The estimated marginal returns to years of education using KLIPS (Korea Labor Income Panel Study) data is 0.07 (7 percent) in household income and 0.08-0.09 (8-9 percent) in individual income which is lower

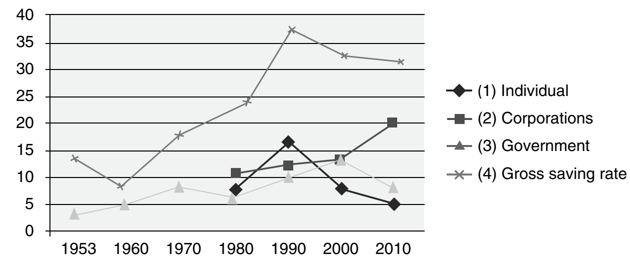
Table 1 The Proportion of Households Saving for Selected Motives by the Age Group of the Household Head

	20-24	25-29	30-34	35-39	40-44	45-49	50-54	55-59	60-64	65-69	70-74	75-
(1) Education	0.0	2.7	11.4	16.9	21.9	19.2	9.7	2.2	1.8	3.3	3.7	10.2
(2) Housing	21.4	19.2	26.5	13.4	7.8	4.4	3.3	2.5	2.3	3.3	1.2	8.2
(3) Consumer durables	0.0	0.0	0.5	0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(4) Marriage	71.4	31.5	9.0	2.5	1.0	3.9	10.8	24.3	19.8	16.0	11.1	10.2
(5) Illness	0.0	33.6	31.9	46.8	45.2	51.6	54.6	53.6	48.4	45.3	51.9	38.8
(6) Retirement	0.0	8.2	15.8	16.5	20.4	19.5	19.2	15.8	25.3	26.0	28.4	26.5
(7) Leisure	7.1	1.4	0.2	0.2	0.0	0.5	0.0	0.0	0.0	2.7	2.5	0.0
(8) Business	0.0	0.0	0.7	0.4	1.0	0.2	0.8	0.3	0.5	0.7	0.0	0.0
(9) Debt	0.0	0.7	1.2	1.9	1.3	0.5	0.5	0.3	0.5	0.0	0.0	0.0
(10) Other	0.0	2.7	2.7	1.0	1.5	0.2	1.0	0.9	1.4	2.7	1.2	6.1

Sources: KLIPS Data

than the world average and the Asian average (0.10, 10 percent). Korea's estimated returns to schooling in earlier studies were 0.09-0.14 for high school graduates. It was mainly due to the baby boom factor, but it calls attention to the role of private versus public education. While Korea's educational attainment is remarkable, the resulting issue of how to support the retirees in a fast-aging society remains as a challenging issue. Estimates of returns to schooling indicate the marginal returns to schooling have started to decline. There was a likelihood of over-investment in education and under-investment in retirement by baby boom parents in Korea. Since there is a strong motive for savings to prepare for large medical expenses, the private pension system needs to be combined with the private medical insurance system.

Figure 2 Trend in Saving Rates in Korea (1953-2010)



Sources: The Bank of Korea, National Accounts, (selected years)

Trend in Savings Rates and Its Decomposition

I have examined the overall savings rate and its trend in Korea to identify simultaneous effects of education and household savings. As shown in Table 2 and Figure 2, the gross savings rate was only 9 percent in 1960, with a private savings rate of 5 percent and government savings rate of 4 percent. But both gross savings rate and private savings rate increased sharply to reach their peaks of 37.5 percent and 29.2 percent respectively in 1990. The increase in private household savings rate has been instrumental to educational expansion because the role of private education has dominated that of public education in Korea.

According to Horioka (1994)[6], Japan reached a net national savings rate of 23.6 percent in 1990 ranking third among 24 OECD countries, and a net household savings rate of 14.3 percent in 1989 ranking fourth among 18 OECD countries. He concludes that Japan's saving rate would still be higher than average even if all measurement problems such as the treatment of capital consumption allowances could be resolved. Korea seems to have reached Japan's level during the 1980s, earlier than 1990. However, Korea's private household savings rate started to fall rather rapidly after 1990 and returned in 2010 to the same level (5 percent) as it was in 1960. It was substituted by the corporate savings rate (20.2 percent) in 2010. One of the reasons behind Korea's rather rapid household savings rate during the 1980s seems to lie in the need to save for children's education. On the other hand its rather rapid decline during the late 1990s and 2000s seems to reflect high costs of medical expenses and education through the two financial crises of 1997-1998 and 2007-2008.

In addition, there are two other factors which have worked jointly to increase households' consumption and decrease their savings. One is the development of financial markets which provided wider choices of payment methods, including credit cards and debit cards, so that households' consumption has been rapidly increasing, including internet banking transactions. The other factor was the cumulative effects of market-opening for foreign goods since joining WTO and OECD in the mid-1990s. The influx of foreign goods through large retail chain stores have opened up consumption opportunities of the households and their conspicuous consumption. The financial crises have also induced firms to retain more savings crowding out household savings.

South Korea and the United States launched a ministerial consultation channel on implementing their bilateral free trade agreement by forming a joint committee on May 17, 2012.

Table 2 Trend in Saving Rates in Korea (1953-2010)

	1953	1960	1970	1980	1990	2000	2010
Gross saving rate	13.1	9.0	19.0	24.4	37.5	33.0	32.0
Private	11.1	5.0	11.9	19.1	29.2	21.4	25.2
(Individual)				(8.3)	(16.7)	(8.6)	(5.0)
(Corporations)				(10.8)	(12.5)	(12.8)	(20.2)
Government	2.0	4.0	7.1	5.2	8.3	11.6	6.8

Sources: The Bank of Korea, National Accounts (selected years)

The joint committee is mandated under the KORUS FTA, which took effect in March 2012. The ministerial mechanism is tasked with supervising the operations of 19 subcommittees and working groups aimed at the smooth implementation of the accord, including solving disputes over interpretations of the terms. South Korea's opposition parties claim this investment safeguard mechanism undermines South Korea's legal independence by allowing U.S. companies to take action against Seoul's policy decisions. They demand Seoul address the concern by altering relevant clauses that they argue unfairly favor American firms with long experience in legal battles against a foreign government. On the investor-state dispute clause in the KORUS FTA, Korean Trade Minister Bark Taeho said it will be handled in the service and investment committee. In early May, South Korea announced the start of FTA talks with China. At a trilateral summit meeting in Beijing, the leaders of South Korea, China, and Japan agreed to launch negotiations on a three-way FTA this year.

Prospect for Sustainable Growth

Economic forecasts for the Korean economy in 2012 by global investment banks (JP Morgan, Deutsche Bank and Nomura) have been adjusted downward from their forecasts of real GDP growth of 3.0-3.6 percent at the end of 2011 to 2.7-3.3 percent in March 2012. This is based on their projections of sluggish export demands due to the continuing European fiscal crisis, higher oil prices and reduced Chinese economic growth. Citigroup forecasts Korean export growth as limited to 6.6 percent and 7.5 percent during the first two quarters of 2012, and Goldman Sachs forecasts a yearly export growth of 5 percent. The most recent forecast by the Asian Development Bank released in April 2012 is 3.3 percent, which is lower than the government's target economic growth rate of 3.7 percent. They also point out that domestic demand including both household consumption and corporate investment will be sluggish due to household debt, as well as the uncertain investment environment in 2012 with both the assembly general election in April and the presidential election in December.

The public has been disappointed by the failed vision by the Lee Government and the net consequence of very minimal increase in their real earnings. It has created room for increasing welfare demands and a progressive agenda for big conglomerate (*Chaebol*) reforms. The result of the general election on April 11 will influence the presidential election in December 2012 and many experts are predicting a very tight presidential race. In addition, if North Korea attempts another nuclear detonation or military adventure, it will also affect the presidential election in South Korea. In this respect, the political economy of South Korea will inevitably depend on the prospect of the new international political order in Northeast Asia.

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