THE KOREAN ECONOMY IN THE SWIRL OF PANDEMIC

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Abstract

After an initial surge in cases, Korea was less seriously affected by the COVID-19 virus than other countries, but the subsequent recovery was relatively mild. The negative effect was concentrated among low-income earners such as temporary, low-skilled, and small company workers, worsening income distribution. Expansionary monetary and fiscal policies contributed to an economic rebound, but the overall policy stance was not as aggressive as those in other advanced countries. While the Korean economy is expected to continue on a recovery path, downside risks are lurking, such as accumulated household debt in conjunction with ballooning apartment prices that may face some correction over the course of global monetary policy normalization. Beyond cyclical fluctuations, the COVID-19 recession will also cause structural changes that are likely to intensify bipolarization and social tensions. In this regard, establishing the leadership necessary to enable the Korean economy to cope with increasing social tensions will become the most challenging task for the next government scheduled to take office in 2022.

1. The COVID-19 Recession and Recovery

1.1. Outbreak of COVID-19 and Vaccination

The global economy in 2020 was swamped by the coronavirus, COVID-19. Few anticipated it would become such a severe disaster when first discovered in China around the turn of the year, but it began to spread around the world so rapidly as to be officially declared a pandemic by the World Health Organization (WHO) within only two months. In order to mitigate the virus contagion, most countries imposed mandatory mask-wearing, social distancing, movement restrictions, and even lockdowns, which inevitably left historic scars on the economy. Considering the extreme policy measures, it may not be surprising that the global economy contracted by more than 3 percent in 2020, with the unprecedented contraction of approximately 10 percent in the first half (Figure 1).

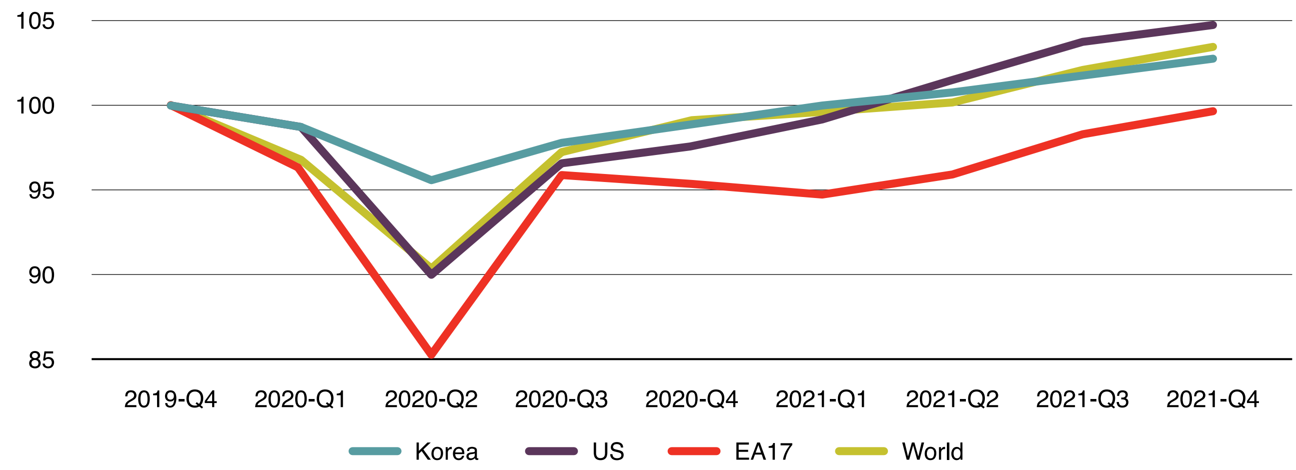
Korea, too, was swept up in the swirl of the pandemic relatively early due to its geographical proximity to China. After the first case was reported on January 20th, the virus began to widely spread out in February, infamizing Korea as the most noticeably infected country in the world for a while. Soon after, however, the number of confirmed patients skyrocketed in Europe and America, overwhelming their medical systems, and all of sudden Korea was made to look like a safe haven compared to the pandemonium in other countries. Unlike many other countries, throughout the whole pandemic period Korea managed to weather through the chaos with mandatory mask wearing, contact tracing, and social distancing policies, not relying on complete lockdowns, thanks to well-established medical systems and voluntary public cooperation with preventive government policies.

Economic performances in 2020 simply mirrored the severities of COVID-19 situations. As a country less seriously infected by the virus, Korea contracted far less than other countries until the second quarter of 2020—approximately a 4 percent loss in GDP relative to 10 percent of the world average. From the third quarter, Korea also began to recover along with the strong rebound of the global economy, but the recovery pace of domestic demand was not as strong as that of exports. Especially, face-to-face service businesses such as tourism, restaurants, sports, and entertainment became enervated whenever the number of confirmed cases increased, and thus the social distancing policy was strengthened. As a result, the (seasonally adjusted) service production index that decreased by approximately 8 percent in March 2020 could not fully recover to the pre-crisis level until the end of the year because the second wave of the pandemic in August and the third in December repeatedly interrupted the recovery pace of businesses. This was in contrast to the manufacturing production index, which collapsed by more than 13 percent in May 2020, and was able to fully recover to its pre-crisis level in September, or in just four months.

Entering 2021, the focus of the game was shifted from the policies controlling social gatherings to the procurement of vaccines that became available at last. Korea was not really agile in this new round of global competition for vaccines, and thus could not take a step forward to a "living with-corona" phase until the third quarter of 2021. Prolonged social distancing policies then continued to hamper the recovery pace of domestic demand (face-to-face service consumption in particular). For example, private consumption in the third quarter was still wobbling around 2.4 percent lower than the pre-crisis level, while the GDP more than fully recovered thanks to revitalized exports.

Currently, Korea is expected to grow at the rate of around 4 percent in 2021, which is lower than those rates of other advanced countries. Of course, it is true that the relatively modest pace of Korea's recovery in 2021 is mostly attributable to its mild recession in the previous year. Yet, the technical "base effect" may not be the full story. The Organization for Economic Cooperation and Development (OECD) expects that, having gone through the two years of a roller coasting business cycle, Korea can attain approximately 3 percent higher GDP than the pre-crisis level by the end of 2021. This is similar to the world average and lower than 5 percent for the U.S., though higher than 0 percent for the Euro area (Figure 1). In retrospect, after the strong gust of COVID-19, it seems clear that Korea's preventive measures were effective for holding out against the virus's onslaught in the beginning, but the policies sticking to social controls hindered the economy from recovering via its own resiliency in the long run.

Figure 1 Recovery Paces of GDP (2019 Q4 = 100)



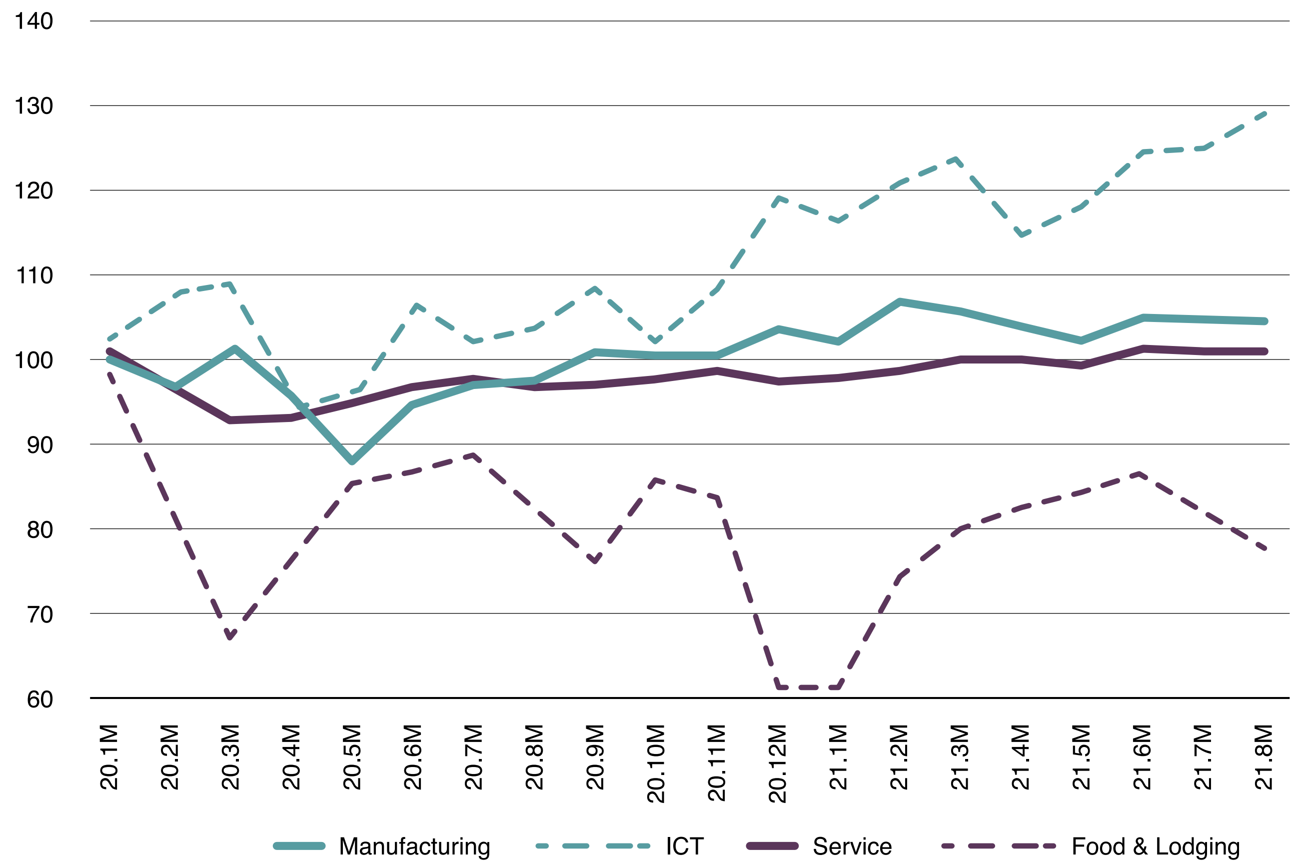
Note: EA17 refers to 17 Euro area countries.

Source: OECD, Real GDP Forecast, https://data.oecd.org/gdp/real-gdp-forecast.htm.

1.2. Uneven Damages

A prominent characteristic of the COVID-19 crisis was that the incurred damages were quite uneven across sectors. Demand for "contact businesses" was severely contracted, but some "untact businesses" rather benefited as demand switched over from the contact businesses. Also important on the production side was how much business had to rely on human work as opposed to capital. In this regard, it seems to be a reasonable first approximation to the reality that labor-intensive service industries were more severely hit by the crisis than capital-intensive manufacturing industries. Even among service industries, situations were diverse. Industries that require close human contact, such as food and lodging, and sports and leisure, were most directly affected by the prolonged social distancing policies, and are still stumbling at less than 80 percent of the pre-crisis production levels, as of August 2021 (Figure 2). In contrast, retail industries managed to evade the shocks by swiftly evolving into untact delivery services that utilized readily available mobile infrastructures. As for manufacturing industries, ICT sectors achieved outstanding performance thanks to the global demand explosion of untact businesses, recording an approximately 30 percent increase in production compared to the pre-crisis level.

Figure 2 Uneven Recoveries (January 2020 = 100)



Source: Statistics Korea, Industrial Production, http://kosis.kr.

From the aggregate production perspective, the shift of the global demand toward untact businesses may have been good news for Korea, which is equipped with a strong ICT industrial base, but it did not greatly help increase employment, as the ICT sector is extremely capital- intensive. Despite the GDP recovery relying on manufacturing industries, the employment situation did not visibly improve as long as labor-absorbing service industries lagged behind. According to the official statistic, while total employment reached the pre-crisis level in September 2020, the unemployment rate has been fluctuating at low levels around 3 to 4 percent with no clear increases in response to the COVID-19 shock. However, it is well known that Korea's unemployment rate is quite insensitive to business fluctuations because most of those who lost their jobs tend to be classified as economically non-active population rather than unemployed. In response to this criticism, Statistics Korea released a supplementary unemployment rate that included "those who wish to work more hours" and "those who have potential willingness to work," which appears to have better reflected the labor market situation. This statistic jumped up from around 11 percent to around 14 percent at the breakout of the crisis in March 2020, and has only marginally declined to around 13 percent despite the aggregate GDP and total employment recovery.

Perhaps a more serious problem than overall employment was that the shock was concentrated towards low-income earners. It is generally the case that export manufacturing industries are led by a small number of large firms with high salary workers, whereas contact service industries are mostly run by small firms with low salary workers or the self-employed. For example, Statistics Korea reports that the average monthly wages are 3.7 million won for manufacturing, 2.8 million won for wholesale and retail, and 1.6 million won for food and lodging in 2019. Given the huge differences in wages across industries, it was tragic that the low-wage sectors were more severely hit by the crisis, as clearly manifested by the employment statistics: compared to the fourth quarter 2019, the (seasonally adjusted) the number of employed in the third quarter 2021 decreased by 2.5 percent in manufacturing, 7.9 percent in wholesale and retail, and 11.2 percent in food and lodging.

No wonder income distribution had worsened. According to the estimates of Sang-Yoon Song,[1] for example, the average income of the lowest quintile households during the period from the second to fourth quarters in 2020 decreased by 17.1 percent compared to that during the same period in 2019, whereas it decreased by only 1.5 percent for the highest quintile households. He also found that approximately one third of the income decrease for the lowest quintile households was due to job losses, and the remaining two thirds was attributed to the decline in income flows of those who were still employed in "high-contact businesses." In addition, as in many countries, COVID-19 disproportionately harmed female employment in Korea. In this regard, the finding of Jiyeon Kim[2] is interesting in that the rise in non-participation is especially pronounced among married women aged 39-44, the group most likely to have elementary-school-age children. This peculiar result suggests the possibility that school closures and a consequent increase in childcare and homeschooling demands discouraged labor market participation by working mothers. Other research results also consistently show that temporary, low-skilled, and small company workers were hit more severely than regular, high-skilled, and large company workers. As such, the COVID-19 recession imposed heavier tolls on the socially vulnerable class.

2. Policy Responses

2.1. Monetary Easing and Inflation

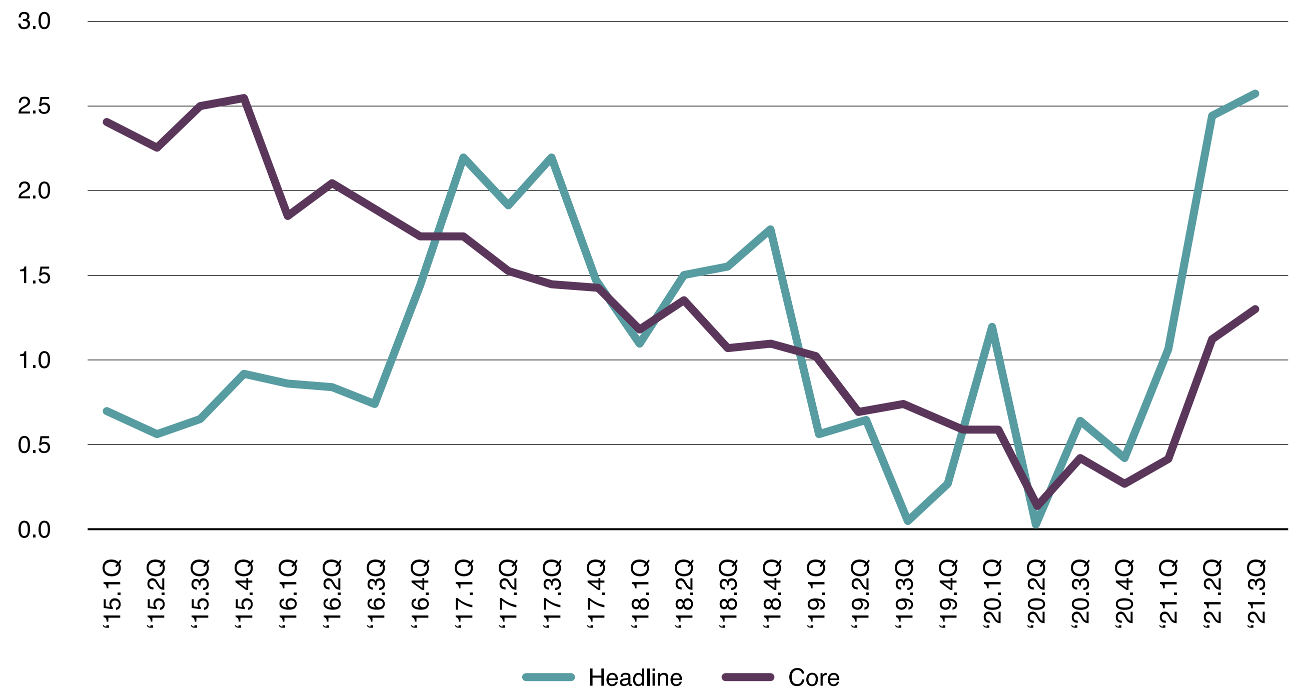
In response to the COVID-19 shock, monetary policy took the role of the first line of defense. The U.S. FED drastically cut the policy rate from 1.50~1.75 percent to 0.00~0.25 percent, the level perceived to be a lower bound, within two weeks in March 2020. Many other central banks followed to lower their policy rates, and the Bank of Korea (BOK) joined in this procession by cutting the rate from 1.25 percent to 0.75 percent in March and further to 0.50 percent in May. The policy rate of 0.50 percent may not have looked exceptionally low compared to virtually zero rates in other advanced regions, but it was a big stride in Korea that had not seen the policy rate lower than 1.25 percent before then.

In addition, the BOK extended its loan policies to non-bank financial institutions including securities companies that were suffering from sudden liquidity shortages due to the global financial market instabilities. The currency swap signed between the BOK and the FED also helped to sooth the tension that was growing in the foreign exchange market upon the outbreak of the crisis. With these policy efforts, the financial market woes were relieved fairly soon. The exchange rate was stabilized in April, and then stock prices surged by more than 50 percent for the subsequent 12 months.

Perhaps more importantly, the aggressive monetary easing succeeded in protecting the Korean economy from falling into deflation. Judging by the core price measure (excluding volatile energy and food prices) that is supposed to better reflect underlying inflation pressures than the headline consumer price index (CPI), Korea's inflation had been apparently on a downward trend for more than five years. Actually, the inflation-indexed government bond market had set their long-term inflation expectation at below 1 percent since 2015. Concerns about deflation possibilities, which had gradually crept out around the financial market, became conspicuous when the pandemic recession broke out and inflation was pushed further down to around zero in the first half of 2020.

Such concerns did not last long, however, as inflation began to bounce back from the third quarter of 2020 thanks to the easy monetary policy along with global recovery. Inflation has continued to climb up since then, yielding the annual rate of 2021 that is likely to exceed the BOK's target of 2 percent for the first time in ten years. While relatively persistent prices for services such as eating out and housing rental costs also began to rise, a substantial portion of the current inflation should be attributed to the "base effect" of the previous year's low inflation and the global energy price hikes, both of which are not expected to last for long. With these grounds, it seems to be a fair assessment at the moment that the Korean economy is just getting out of deflation risks and moving toward the targeted inflation state rather than entering into an unbridled inflation phase.

Figure 3 Turnaround of Inflation



Source: Statistics Korea, Consumer Price Index, http://kosis.kr.

Nonetheless, the BOK decided to become the first mover to the journey of monetary policy normalization among major central banks in advanced countries, by raising the policy rate from 0.50 to 0.75 percent in August and signaling another rate hike to 1.00 percent in November. This preemptive action of the BOK may not be suitably justified by conventional yardsticks for monetary policy such as inflation and growth. Considering the GDP loss of around 1 percent in 2020, the expected GDP gain of 4 percent in 2021 is insufficient to bring the overall economic vitality back to a potential level that is supposed to grow at the rate of 2 percent every year. Perhaps the negative GDP gap, the difference between actual and potential GDP, can vanish in the second half of 2022 if the economy continues to grow at the rate of 3 percent.

Against this backdrop, the BOK does not conceal its policy intention for "financial stability" that aims at curbing the housing price hikes and household debt accumulation. Seoul's apartment prices have risen by more than 50 percent over the past five years, and the household debt to disposable income ratio has increased from 130 percent to over 160 percent during the same period. While most economists are concerned about these financial stretching problems in Korea, many challenging issues remain unresolved about whether monetary policy should respond to "financial imbalances" including asset price fluctuations and, if so, by how much at the expense of achieving the inflation target.

2.2. Fiscal Support

The fear about the uncharted pandemic recession was intense enough to induce large-scale fiscal policies in addition to monetary easing. Especially for most advanced countries in which policy interest rates were near lower bounds, fiscal policy was expected to play a more active role to mitigate the severity of the recession. Another rationale for aggressive fiscal responses was also provided in relation to the nature of the recession. Since the adverse impacts of COVID-19 were concentrated on particular sectors, fiscal policy responses were more suitable for supporting targeted people than monetary policy, the effects of which are basically indiscriminative.

The Korean government also implemented fiscal stimulus packages by preparing supplementary budgets four times in the single year of 2020, which was so exceptional as to become the first case since 1961. Yet, the magnitude of resources mobilized through the four supplementary budgets, 67 trillion won or approximately 3.5 percent of GDP, was far smaller than the scales of stimulus packages executed in major advanced countries, not to mention the scale of the U.S., 16.7 percent of the GDP, according to the Fiscal Measure Database of the International Monetary Fund (IMF). The relatively conservative fiscal stance of Korea could hardly be attributable to the immediate financial risks of the government: Korea's national debt to GDP ratio, below 50 percent, is far lower than those of most advanced countries exceeding 100 percent. Nevertheless, the general public are fully aware of the longer-term fiscal burdens that will be sure to arise from the rapid aging in demography coupled with the world's lowest fertility rate, in addition to the possibility of an abrupt increase in unification costs. These concerns were, in fact, actively expressed by opinion leaders as well as opposition parties, restraining the government from aggressively expanding fiscal expenditure. In addition, the conservative fiscal stance was further justified by the relatively mild recession of the Korean economy, which mitigated the feeling of crisis which would otherwise have called for a larger-scale fiscal stimulus plan.

Aside from the scales of stimulus packages, their contents were not particularly extraordinary: covering unemployment insurance, support for small and medium-sized enterprises, subsidies for job retention, and so on. Yet, a controversy was sparked over the universal cash subsidies implemented for the first time in Korean history. Some argued for selective supports to those who suffered more, while others preferred universal support. In retrospect, the first universal subsidization policy implemented immediately after the outbreak of the COVID-19 shock can be justified, in that it was not easy to identify who would suffer more while the economy was desperately craving supportive policies. Perhaps the critique on universal support programs is more legitimate to the second round of universal subsidization policy carried out in 2021 when those who were damaged more were clearly identified while the recovery trend became evident.

Regarding the boosting effect of the universal cash subsidies, a wide range of estimates for fiscal multiplier (the increase in aggregate demand induced by a unit increase in fiscal expenditure) have been presented from almost 0 to 60 percent depending upon the employed estimation methodologies and data. Among them, the result of Meeroo Kim and Yoon Hae Oh[3] is informative. Examining the credit card sales data during the first round of subsidization period, they found that the boosting effects were small, short-lived (fewer than two months), and concentrated on (semi)-durable goods rather than the high-contact face-to-face service sectors that the COVID-19 pandemic hit most directly.

3. Looking Ahead

There appears to be a consensus that the Korean economy will be able to continue the recovery trend at a growth rate of around 3 percent in 2022. The main ground for this optimism is the anticipated policy shift toward a "living with-corona" state. Although Korea was unsuccessful in the early stage of vaccine competition, the share of vaccinated people is steadily rising as vaccines are becoming increasingly common. In fact, the vaccination rate of Korea is expected to exceed those rates of other major advanced countries by the end of 2021, mainly due to the social atmosphere of little resistance to medical treatments. Based on the progress in vaccination, preventive measures like social distancing and quarantines will be relaxed, which is highly likely to unleash pent up demand for dining out, entertainment, travel, and so forth. As an open economy heavily dependent upon export demand, the optimistic scenario for Korea can be strengthened if the economies of the world's countries, including those countries lagging behind in vaccination, are moving forward all together.

However, downside risks are lurking. Internally, the accumulated household debt in conjunction with ballooned apartment prices during the low interest rate period is the most widely referenced risk factor. While the stringent macro-prudential measures, represented by the extremely low loan-to-value regulation of 40 percent in place, may be able to protect the banking system from a possible correction of asset prices, the financial risks of highly indebted households will inevitably be increased as interest rates rise and asset prices adjust.

The concern about the financial market situation is not just a domestic issue. As the economy recovers and inflation bounces, global monetary policy that has been stretched to an unprecedented level is about to rewind. Though the FED has made efforts to minimize unintended side effects through continuous communications, retrieving liquidities from the financial market is always a risky business. The related market anxiety that monetary contraction may be precipitated appears to be growing as the higher than expected inflation driven by skyrocketing energy prices persists.

Apart from financial risks, disruptions in international supply chains are also an important risk factor. As cross-country mobility is still restricted to a large extent, the advantages of international production divisions that have been explored during the globalization period are significantly hampered. Some parts production factories in developing countries operate unreliably, and quite often the produced parts are not delivered on time. Particularly important for the case of Korea in this respect is the supply chain that many Korean manufacturers have established over decades with Southeast Asian countries. Given that the U.S.-China conflict does not seem to be easing in the near future, this region has been emerging as the most attractive production base alternative to China for Korea. If the severity of the pandemic situation in the region does not improve as fast as expected, it will surely drag down the recovery pace of Korea's manufacturing production.

Beyond cyclical fluctuations, the COVID-19 recession will also cause structural changes in many respects. An apparent example is that the trend toward contact-free businesses will be reinforced as the awareness of infection risks are heightened. It is true that such a trend has been with us for decades ever since the "information revolution" was triggered by the proliferation of internet services, but the trend is significantly accelerating after the COVID-19 recession. Internet shopping combined with home delivery services is becoming a norm rather than a high-end fashion for consumers, and an automated order system in place of waiting staff is commonly observed at restaurants. Remote lecturing, which had to be introduced due to the prohibition of class gatherings in person, is likely to settle in as an alternative education vehicle in the post-pandemic era, as both students and teachers have gotten accustomed to it.

Structural changes in output markets are inevitably leading to the changes in input markets as well. While investments on information-related and untact businesses are substantially increasing in the capital market, demand for workers with computer skills is exploding in the labor market. Types of jobs are also being diversified from the eight-hour workday at a regular office to a flexible-time hybrid of working at home and at an office, as web-based conferences and work from home are becoming common.

All of these changes are natural responses of the market to adapt itself to the new environment revealed by COVID-19. As long as the trend is unlikely to crank back, nimble and flexible adjustments are needed to enhance the overall economic efficiency. At the same time, however, it is also the case that rapid structural changes are likely to leave behind many people who do not quickly adapt themselves. This trend of bipolarization will intensify the social tensions between the young who are already used to the digitalized world and the old who are not, in addition to the long-lived tension between those who have and those who have not. In this regard, establishing the leadership enabling the Korean economy to cruise through increasing social tensions will become the most challenging task for the next government that is scheduled to launch in 2022.

Author Identification

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[3] Meeroo Kim and Yoon Hae Yoh, "The Impact of COVID-19 Regional Cash Subsidies on the Sales of Local Businesses in South Korea," *KDI Journal of Economic Policy* 2021, 43 (2):103-123.