Republic of Korea

After a robust recovery in 1994, Korea's economic growth unexpectedly accelerated further in 1995, mainly because of brisk investment and vigorous export growth. Despite phenomenal expansion, the economy did not overheat. In fact, inflation in 1995 was reduced from the previous year's rate as excess demand pressure was moderated; moreover, wage increases were kept modest, in part because of improved business-labor relations.

Economic activity is projected to moderate somewhat over the next two years, with the GDP growth rate more consonant with Korea's economic potential. Exports will continue to be the main engine of growth, with new investment playing a lesser role; inflation is projected to continue declining in 1996 and 1997 to historically low levels.

In the coming years, Korea will face new external influences as liberalization of the capital account is accelerated and the country's membership in the OECD takes effect by the end of 1996. Monetary policy is likely to have a bigger task in maintaining domestic price stability and in dealing with larger capital flows and wider exchange rate fluctuations. For a smooth adjustment to greater openness, the Government plans to reduce interest rate differentials by maintaining stable prices and wages. Both monetary and fiscal policies will have to conform to the requirements of macroeconomic stability while financial and fiscal reforms continue.

Recent Trends and Prospects

Growth, Investment, and Employment. The remarkable economic upswing that occurred in 1994 persisted unexpectedly in 1995, with GDP growth rising to 9.2 percent from 8.4 percent in 1994. All principal sectors shared in the improved performance. Agriculture registered the strongest improvement, with output expanding by slightly above 6 percent compared with 1.2 percent in 1994. Forestry and fisheries output, however, contracted. Industrial production rose by 11.4 percent, with manufacturing output expanding at 11.5 percent, up from 10.4 percent in 1994. Heavy and chemical industry products for export continued to be the main players in manufacturing. The services sector expanded by 8.5 percent in 1995, slightly better than in 1994, with transportation and communications taking the lead.

Private consumption growth, in real terms, picked up from 7.4 percent in 1994 to 8.1 percent in 1995 with increased spending on durable and semi-durable goods. By contrast, government consumption remained weak, with growth diminishing to 3.1 percent from 4.4 percent in the previous year, as some expenditures were postponed for countercyclical fine-tuning.

As in 1994, investment played a leading role, maintaining real growth of nearly 16 percent, with equipment investment alone increasing by around 13 percent. This was brought about by the continuing expansion of capacity in the heavy and chemical industries, particularly electronics, semiconductors, and automobiles which are also major export industries (Figure 2.2). Investment in construction climbed at a more modest rate of 9.2 percent, but even this was an advance on the previous year's 4.6 percent increase. Overall, gross domestic investment rose further to 36.6 percent of GDP in 1995 from just below 36 percent in 1994. However, with the savings rate increasing to 37 percent of GDP, a small surplus emerged. Employment growth was robust at about 2.5 percent, with the construction industry and the services sector registering the largest increases. Although employment expansion in manufacturing was more modest, it was a significant improvement over that in 1994. The overall unemployment rate dropped in 1995 to an historical low of under 2 percent. The consequent tightening of the labor market is leading the Government to consider the admission of more foreign workers, who currently number between 80,000 and 100,000, excluding illegal migrant laborers.

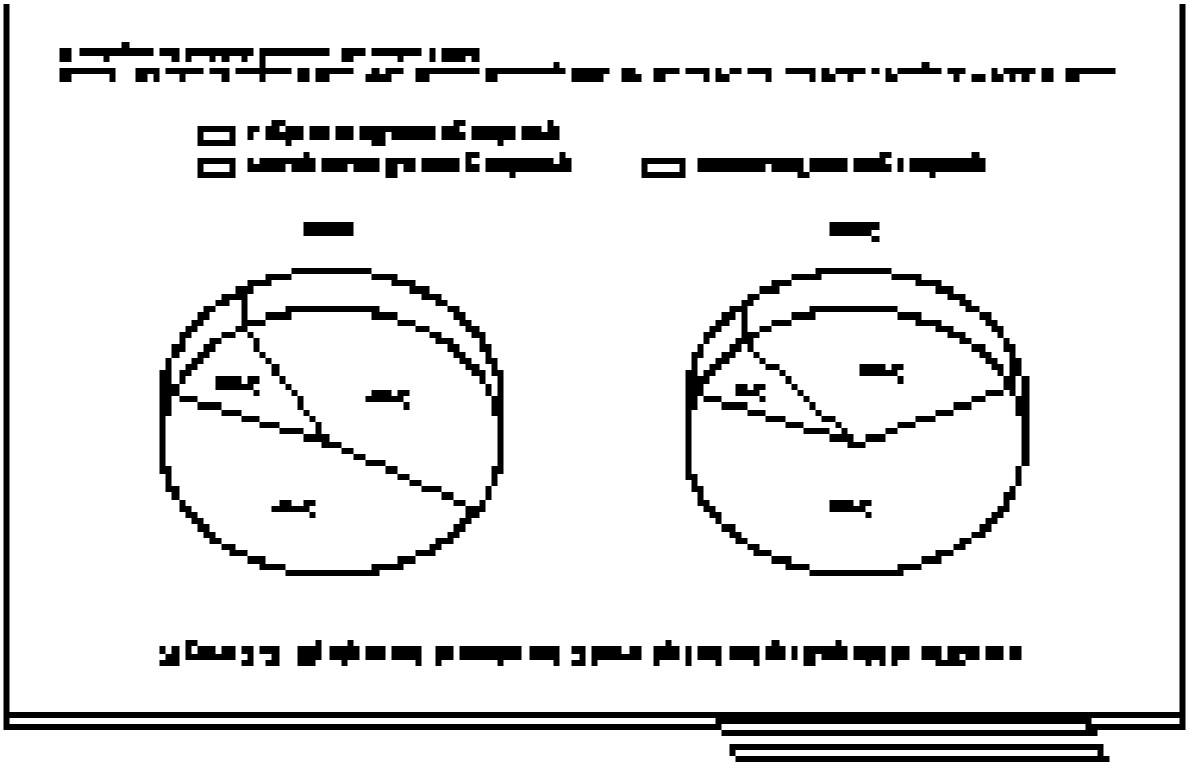
The economy is forecast to move toward a more sustainable growth path of 7–7.5 percent in 1996 and 1997. This should be achievable as there are no signs of overheating at this phase of the business cycle, in contrast to the experience during previous economic upswings. The industry sector is likely to expand at the same rate as the aggregate economy; the services sector will expand at a somewhat higher rate. Agricultural growth is expected to slow considerably to 2–2.5 percent over the same period. Although the growth of exports and investment is expected to diminish with the slower pace of overall economic activity, exports are projected to keep the growth momentum from falling below the economy's potential. Private consumption, which is likely to be influenced more by income and wage increases than by wealth changes as happened in 1994 and 1995, will grow by just above 7 percent annually during 1996 and 1997.

Gross domestic investment will recede slightly to about 35.4 percent of GDP on average in the next two years; however, the savings rate is likely to remain at 37 percent or better, thereby improving the surplus achieved in 1995. While the new comprehensive income tax system, which will cover interest and dividend incomes, and the new installment credit system will have a negative effect on private saving, this will be offset by a staged increase in the contribution rate to the national pension plan from the current 6 percent to 9 percent by 1998. The unemployment rate is projected to edge up to around 3 percent owing to lower

Table 2.2 Major Economic Indicators: Republic of Korea

		1993	1994	1995	1996	1997
Gross Domestic Product	% change	5.8	8.4	9.2	7.5	7.0
Agriculture	% change	-2.9	1.2	6.1	2.5	2.0
Industry	% change	4.9	10.2	11.4	7.6	6.7
Services	% change	7.3	8.4	8.5	8.0	7.3
Gross Domestic Investment	% of GDP	35.1	35.9	36.6	35.5	35.2
Gross Domestic Saving	% of GDP	35.4	35.5	37.0	37.1	37.2
Inflation Rate	% change in CPI	4.8	6.2	4.5	4.3	3.9
Money Supply Growth	% change	16.6	18.7	15.0	14.5	14.0
Merchandise Exports	$ billion	80.9	93.7	124.0	141.8	161.9
	% change	7.7	15.7	32.4	14.3	14.2
Merchandise Imports	$ billion	79.1	96.8	129.0	144.2	163.0
	% change	2.3	22.3	33.3	11.8	13.0
Current Account Balance	$ billion	1.0	-3.9	-8.6	-5.9	-4.4
	% of GDP	0.3	-1.0	-1.9	-1.2	-0.8
External Debt Outstanding	$ billion	47.2	54.5	48.0	44.5	42.1
Debt-Service Ratio	% of exports	9.2	6.8	4.9	4.8	4.7

Sources: International Monetary Fund, *International Financial Statistics* (Washington, DC, February 1996); Jun Il Kim, "The Korean Economy 1995–97, Recent Trends and Future Prospects," Korea Development Institute (mimeo, December 1995); World Bank, *World Debt Tables 1996*, Vol. 2 (Washington DC, 1996); and staff estimates.



economic growth and the likely adverse effects of the unemployment insurance plan on the labor supply.

Budget, Money, and Prices. In the 1995 budget, total expenditure and net lending together rose by almost 15 percent compared with the 21.3 percent increase in 1994. A smaller deficit of roughly 0.3 percent of GDP, which was programmed at the beginning of the year, was easily achieved because of higher-than-expected growth in tax revenue. The excess revenue of about won (W) 1.8 trillion more than covered increased spending for special investment and for educational facilities, as well as expenses for rice donations to North Korea. The surplus was in fact much larger at midyear as the Government deliberately reduced spending during the first half of the year to forestall a possible overheating of the economy. Capital spending was instead concentrated during the second half of 1995.

Expansion of the money supply (M2) was tighter at 15 percent compared with 18.7 percent in 1994. Private and foreign sources were dominant, with the contribution of the government sector being negative. Despite the robust growth of investment and relatively tight money supply, interest rates remained low, with the corporate bond yield hovering at around 12–13 percent. Low interest rates can be attributed mainly to stable consumer prices, higher cash flows and business profits of large firms, and increased foreign currency loans that facilitated the financing of private sector investment.

Despite the economic boom in 1995, inflationary pressures were moderate by historical standards, with the increase in the CPI falling to 4.5 percent from the previous year's 6.2 percent. Excess demand pressure, which had been mounting since early 1993, tapered off in 1995. Wage increases were moderate and were linked to steady gains in productivity. Wage stability may be attributed at least in part to improved business-labor relations and the new flexible wage bargaining system.

The budget for 1996 is characterized by the same structure and priorities as the 1995 budget. More resources will be allocated to infrastructure investment, education, technology development, industrial restructuring, and social welfare. Total expenditure is programmed to rise by 16 percent in 1996, somewhat faster than the rate of growth in nominal income. The overall deficit is projected to be smaller at W0.9 trillion compared with W1.1 trillion in 1995, in line with the aim of achieving a smooth transition to lower rates of economic growth in 1996 and 1997.

Given this aim as well as the desire to position the economy for the effects of capital account liberalization, monetary policy for the next two years will be moderately restrictive. Money supply growth is likely to be slightly lower than in 1995 at about 14 percent. Interest rates will also decline somewhat to about 10–12 percent, owing to the expected slowdown in investment demand. Inflation is forecast to be just above 4 percent in 1996 and lower than 4 percent in 1997, as aggregate demand pressure continues to soften, and wage rates remain stable.

External Trade and Payments. Merchandise exports grew by over 32 percent in 1995, about double the previous year's rate. This remarkable export performance was attributable in particular to the strength of the yen. Heavy and chemical industry products dominated the export sector in 1995, expanding by close to 50 percent and accounting for about 70 percent of all merchandise exports. By contrast, light industry shipments increased by only 16 percent, although this was more than double their rate of growth in 1994.

Because of strong domestic demand, particularly for equipment investment, imports expanded even faster than did exports at more than 33 percent, resulting in a worsening of the trade deficit. The rapid growth in imports was largely accounted for by raw materials and capital goods, which grew by more than 30 percent and 40 percent, respectively. Commodity imports for export production alone expanded by nearly 50 percent compared with the increase in imports for domestic use at over 30 percent. Still, the rise in consumer goods imports was higher than in 1994, reflecting the rapid growth in income and high import elasticity. The current account deficit nearly doubled in 1995 to $8.6 billion or 1.9 percent of GDP compared with 1.2 percent in 1994.

With increasing production costs in Korea, the inflow of FDI continued to decline in 1995, while direct investment abroad rose, especially to Southeast Asia and China. By contrast, portfolio investment was brisk, helping fuel the recovery of the stock market and contributing to a capital account surplus of $13–14 billion. Korea's external debt declined slightly to $48 billion from $54.5 billion in 1994, despite the widening current account deficit. The debt-service ratio was stable at 4.9 percent which is low by both historical and international standards. One aspect of some concern is the maturity structure of the external debt as the proportion of short-term debt has been rising in recent years.

Exports are projected to grow less strongly in the next two years, particularly if competitiveness is adversely affected by changes in the yen/won exchange rate. Chemicals, textiles, and garments will be hit the hardest by price effects while computer chips and computer peripherals will continue to do well as exporters improve market share following significant spending on research and development. Export growth is expected to be around 14 percent. Given the slowdown in investment growth, the increase in imports is forecast to decelerate even more sharply to about 12 percent, leading to a narrowing of the trade gap. Thus, the current account deficit will steadily improve to 1.2 percent of GDP in 1996 and to less than 1 percent in 1997.

The capital account balance will continue to record a substantial surplus owing to net inflows as the capital market is further liberalized and the won becomes stronger. External debt is expected to decrease during 1996 and 1997 as private sector borrowing falls with declining investment demand. Likewise, the debt-service ratio is expected to improve.

Policy and Development Issues

Korea has taken a number of steps to make its economy more open in preparation for joining the OECD. Measures introduced during the last two years aim to increase access of foreign investment to equity and bond markets, to liberalize the capital account, and to relax requirements for establishing banks and securities firms. The challenge now is to adopt appropriate macroeconomic policy responses given the potential macroeconomic volatility which these liberalization measures could entail. The Government needs to address the issue of further reform of the trade regime for agricultural products and to improve the delivery of services as well as the autonomy of local governments. Also, structural adjustment by small- and medium-scale industries must be accelerated through policies that provide additional financial resources and relax labor market restrictions.