

# Republic of Korea

## Economic Assessment

The economy expanded by 5.4% in the first half of 2004 from a low base in the year-earlier period, but this masks a slowing from 3.0% in the first quarter to a mere 2.3% in the second, when measured in annualized quarter-on-quarter terms. Growth has been driven mainly by exports, which climbed by 27.1% in the first half from the previous year. Imports rose by 16.1%, picking up pace in the second quarter due to a surge in oil import costs. Net exports accounted for 5.5 percentage points of the first-half GDP growth, outweighing a contraction of 0.1 percentage points from domestic demand (Figure 2.3). Although the export performance remains robust, there are signs of a moderation in growth, led by information and communications technology (ICT) products. For example, semiconductor exports slowed sharply in August, with year-on-year growth decreasing to 29.3%, the lowest rate this year, from 57.3% on average in the first half of 2004.

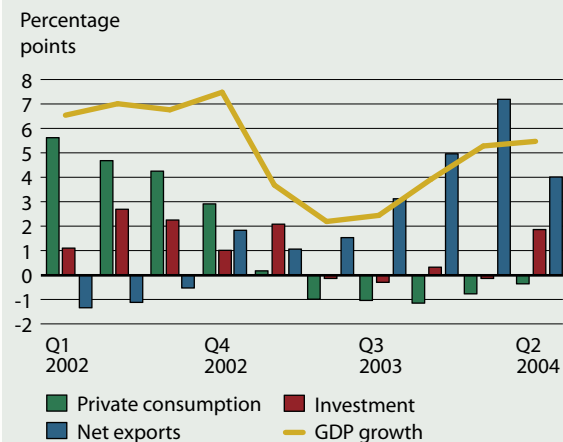
Strong exports, however, have been unable to accelerate a painfully slow recovery in domestic demand. Private consumer spending fell by 1.0% in the first half of the year and shaved 0.6 percentage points from GDP growth. A large overhang of consumer debt built up over the previous 2 years continues to cast a shadow over the economy. Household debt stood at the high level of 73.5% of GDP at the start of 2004. It rose by 7.8% in the first half of 2004, slightly below the increase of 9.1% for all of 2003. Consumers have been more inclined to bring down their debts and bump up their saving than to spend. Private consumption fell on a quarter-on-quarter basis for the third quarter in a row in the April–June period, though the pace of decline eased.

Gross fixed capital formation rose by 3.3% in the first half of 2004 as the surge in exports exerted increasing pressure on production

capacity. Investment in machinery and equipment rose by 6.2% in the second quarter, compared with a contraction of 0.3% in the first, ending 4 consecutive quarters of decline. However, the recent deceleration in export growth raises doubt on the need for further expansion in production capacity, and consequently on the strength and durability of the investment revival. Construction investment remained relatively resilient, despite policy measures to curb speculative activity in the housing market. Even then, growth in construction investment slowed to 3.9% in the first half from 2003's full-year rate of 7.6%. Overall, investment added 0.9 percentage points to first-half GDP growth.

As exports of products such as automobiles and ICT items climbed, manufacturing production rose by 12.8% in the first 6 months of the year. The overall industry sector—manufacturing, mining, utilities, and construction—grew by 10.6%. In contrast, the services sector expanded by just 1.6% because of declines in wholesale and retail trade and

Figure 2.3 Contribution to Growth by Expenditure Component, Republic of Korea, Q1 2002–Q2 2004



Source: Bank of Korea, available: [www.bok.or.kr](http://www.bok.or.kr).

**Table 2.3 Selected Economic Indicators, Republic of Korea, 2004–2005, %**

Item	2004		2005	
	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update
GDP growth	4.8	4.4	5.2	3.6
Inflation (CPI)	3.1	3.8	2.8	3.0
Current account/GDP	2.7	3.9	2.6	3.1

Source: Staff estimates.

in financial services, stemming from the weak private consumption and problems of credit card companies. Agricultural production increased by 3.6% in the first half from the same period a year earlier, after 2 consecutive years of contraction. Construction was held back by a cooling property market.

Business indicators point to a second-half slowdown in activity. The composite index of business leading indicators fell for 3 consecutive months in May–July. Industrial production appears to have peaked in the second quarter—month-on-month growth rates fell in June and July. Also, inventories of some ICT products are rising as their export growth scales down.

A recovery in the labor market faltered late in the first quarter, and 291,000 jobs were lost between February and July. The unemployment rate averaged 3.6% in the first half of 2004, rising from an average of 3.4% in 2003. This job-market weakening does not bode well for what may be the beginnings of a tentative firming in private consumption.

The Government provided support to domestic demand. Government consumption increased by 3.6% in the first half from the prior-year level, contributing 0.4 percentage points to GDP growth. Spending was front-loaded into the first quarter, resulting in a deficit of \$2.0 billion for that period. The Government estimates that the 2004 budget deficit, adjusted for social security contributions and repayment of government-guaranteed debt, will be 0.9% of GDP, well below the Organisation for Economic Co-operation and Development (OECD) average of 3.5% of GDP, providing ample room for further pump priming. Central government revenue collection continued to improve, rising by 14.6% in the first quarter from a year earlier, on account of rising tax revenues

from the export sector. Expenditures in the quarter jumped by 37.3% as the Government tried to stimulate the economy.

Inflation has accelerated, despite the weak domestic demand. The CPI rose by 4.8% and the producer price index by 7.0% in August from 12 months earlier. Although higher oil prices take much of the blame, rising input prices also partly reflect increasing wage pressures. Nominal wages, which had jumped by 9.5% in 2003, rose a further 4.5% in the first half, a period when working hours fell by 0.9%. These trends in wages and working hours are hurting Korea's competitiveness, thus hampering job creation.

The increase in inflation did not, however, deter the Bank of Korea from lowering its policy interest rate from 3.75% to 3.50% in August. The soft economic performance appeared to outweigh rising inflation risks for the markets, which pushed down long-term bond yields in the first half and flattened the yield curve. Notwithstanding easier funding conditions, corporate financing activity remained sluggish. The weakness in investment demand also partly explains a slow recovery in domestic credit. Growth in the M3 money supply was 5.1% in the first quarter and 5.8% in the second, below the 2003 average of 8.8%.

The won gradually strengthened against the US dollar. It fell in May, along with other regional currencies, ahead of the anticipated rise in US interest rates as international investment funds unwound speculative positions. Since then, the won has recouped much of its strength, supported by strong exports and inflows of portfolio investment attracted by export-oriented stocks. Also supporting the won was the robust position of the balance of payments, which remained in surplus and added \$12.7 billion to external reserves in the first half of 2004. The current account surplus rose to \$13.2 billion, helped by an expanded trade surplus, though the capital account switched to a deficit of \$600.0 million, partly reflecting a rebound in direct investment abroad. Korean investment in other Asian economies, mainly the PRC, rose by 53.0% to \$1.3 billion in the first half.

FDI inflows edged up to \$5.0 billion in the 6 months to June. US investors provided about half this amount, with Citicorp's acquisition of

KorAm Bank accounting for \$1.7 billion. Nevertheless, FDI is well below the peak of more than \$15 billion a year seen over 1999–2000. Labor market rigidities concern some foreign investors, and the strong attraction of the PRC for international investors is also diverting FDI away from Korea. However, portfolio investment inflows were buoyant. Equity and bond purchases generated net capital inflows of \$9.6 billion during the first half of the year, despite the sharp withdrawal of portfolio investment in May. With such investment flows resuming after August, the KOSPI stock market index regained some of the losses incurred in May and was little changed as of 1 September from the start of 2004.

### Policy Developments

Economic policies have centered on encouraging investment, private consumption, and job creation; the outlook in these areas has generally deteriorated since *ADO 2004*. More specifically, the authorities have focused on strengthening social welfare, increasing investment in education, promoting research and development, and supporting SMEs.

Fiscal policy has become more expansionary. The central government 2004 budget originally was set at the equivalent of 22.9% of GDP, marginally higher than in 2003. It was aimed at providing a mild fiscal stimulus, mostly in the first half, before progressively returning to a balance. However, a much anticipated recovery in domestic demand did not materialize. As a result, the Government introduced a supplementary budget in May, mainly to allocate extra support for low-income earners. This lifted the central government budget to 23.5% of GDP. In addition, members of the majority political party have proposed a new fiscal package that involves tax cuts and further spending. The tax proposals include a 1.0 percentage point cut in income tax and capital gains tax, an increase in tax deductions for small enterprises, and the abolition of a special excise tax on luxury and high-tech goods. The additional spending will be allocated to research and development, education, and SMEs, if this proposal becomes government policy.

On the monetary front, further easing appears likely. Monetary settings have been accommo-

date since 2003, but private consumption is still struggling to pick up due to the overhang of household debt. The 25 basis point cut in the policy rate in August suggests that the priority is on resuscitating private consumption, even at the cost of higher inflation. However, with real interest rates already negative, monetary policy will have only limited effectiveness.

To address the credit problems, the Government has accelerated the restructuring of troubled credit card companies through capital injections, and mergers and acquisitions. Further reforms are planned in an attempt to build a sound credit culture in banking and financial institutions. However, sluggish spending and credit demand have delayed a recovery in the credit card business. Moreover, an effort in May to restructure overdue consumer loans was unsuccessful because the debtors considered the terms too tough. Against this backdrop, the Government introduced a new program that offers more generous grace periods and interest payments. The amended deal grants debtors a full-year grace period without any principal or interest payments, if they first pay 3% of the outstanding principal. After that year, the accrued interest and remaining 97% of the principal is amortized over 7 years.

### Outlook for 2004–2005

Forecast GDP growth for all of 2004 is now revised down to 4.4%, from 4.8% in *ADO 2004*, and to 3.6% in 2005, from 5.2%. Growth in exports is expected to level off during the rest of 2004 and into 2005, with the ICT industry, a major source of Korea's exports, showing signs of cooling. Export growth will moderate for several reasons: softening demand in markets for high-tech equipment, rising prices of inputs, and the expected reduction in the PRC's growth rate.

While private consumption and investment may be strengthening, the recovery in domestic demand will remain gradual. Recent wholesale and retail sales data show a hesitant improvement in consumption. The wholesale sales index rose by 0.8% in July after a 1.6% gain in June, and the retail sales index posted more modest gains. Over the forecast period, the pickup in private consumption will be constrained by the household debt burden, unfavorable job market conditions,

and the higher cost of oil. The recent rebound in investment remains fragile because it has been confined mainly to the export sector. With exports slowing, the gains in machinery and equipment investment could dwindle. There are indications of slowing factory utilization rates and rising inventories. This suggests that investment growth may peak in the second half of this year, which would limit any substantial improvements in the labor market.

Expansionary macroeconomic policies will continue into 2005. The consolidated fiscal deficit could widen to 1.2% in 2005, from this year's forecast deficit of 0.9%, because the prolonged weakness in private consumption requires further fiscal support. At the same time, tax revenues will decline due to the moderation in the export sector and proposed tax cuts. Low investment demand is likely to contain the growth in the M3 money supply, despite further easing in monetary policy. Reflecting mounting inflationary pressure from the supply side, inflation is expected to remain high at least until the first half of 2005, before subsiding a little in the second half of 2005.

The current account surplus will fall in 2005, reflecting a decline in trade surpluses due to slowing exports and sustained high oil import costs. A reduction in the current account surplus implies a decrease in net national savings, and in fact both private and public sectors are expected to reduce savings in 2005. Households, as they gradually increase consumption, will save less. Firms are likely to save less because profits are expected to grow at a slower rate, or decline, while the Government's expenditures will exceed its revenues.

In the broader picture, concerns abound that deepening structural weaknesses are damaging the domestic investment environment and the economy's long-term growth potential. As Korea makes a structural shift from traditional manufacturing to ICT and services, the changing indus-

trial structure and higher labor productivity have led to a reduction in jobs. Adequate numbers of new jobs are not being created, in part because of rigidities in the labor market, which adds to downward pressures on household incomes. Labor unions at the large, unionized companies have pushed up wages, discouraging those firms from hiring or investing. Many consumers, faced with uncertain incomes and higher oil prices, have cut their spending, damping overall economic activity and thus discouraging firms from investing.

Indebted consumers and a cautious banking industry have contributed to a disjunction between a monetary policy (that is accommodative) and domestic demand (that is unresponsive). If monetary policy is less effective, a stronger fiscal stimulus remains the best option to bolster domestic demand. The proposed new fiscal package, if adopted, should provide a further fiscal stimulus, though it is unclear if it would have much impact in 2004.

However, short-term macroeconomic stimuli can play only a limited role in guiding the economy back onto a long-term sustainable growth path. The postfinancial crisis reforms—once praised by the international financial community for their speed and depth—are increasingly dominated by debates over the distribution of wealth versus economic growth. The focus of recent reforms has been more on socioeconomic concerns, such as increasing transparency in the *chaebol*, improving wealth distribution, upgrading labor conditions, and strengthening the social safety net.

Despite the long-term benefits of some of these policies, the change in focus has unsettled the business community. To reestablish its confidence and revive investment, the reforms should refocus on economic efficiency and productivity through greater flexibility in the labor market, a healthier credit culture in the financial sector, and improved governance and transparency in the corporate sector.