Republic of Korea

Growth surprised on the upside in 2009 as the economy avoided an expected contraction. Fiscal stimulus and better than expected export performance fueled recovery from the impact of the global recession. A sharp rebound in growth is forecast for 2010 as domestic demand picks up and the export recovery broadens. Medium-term policy challenges are to encourage the employment of women and accelerate the transition to economic growth that is based on productivity improvements.

Economic performance

After hitting bottom in the fourth quarter of 2008, when output contracted by 4.5% (quarter on quarter), the Republic of Korea (hereafter Korea) staged a strong recovery in 2009. GDP grew by 0.2% in the year, a much better outcome than expected, although far below the 5-year average of 4.2% in 2004–2008. Figure 3.11.1 shows the year-on-year and quarter-on-quarter trajectory of GDP growth in 2008 and 2009.

Despite weakness of external demand, net exports were the primary driver of growth in 2009 (Figure 3.11.2), helping offset weakness in domestic private demand. Mirroring the impact of a sizable fiscal stimulus, government consumption also contributed substantially to growth. However, private investment dragged down growth throughout 2009. Interestingly, although Korea’s slowdown started as a collapse of exports, net exports helped the economy get back on its feet, while the negative impact of domestic demand on growth persisted.

Exports of goods in real terms plunged in late 2008 and early 2009, then bounced back (Figure 3.11.3), to be flat for the year. Two factors account for the resilience of exports in the face of weakness in industrial economies. First, exports benefited from continued robust appetite for imports from the People’s Republic of China (PRC). Also, the PRC’s fiscal stimulus had positive spillover effects. In particular, subsidies for rural households to buy household appliances benefited Korean electronics exporters. Exports to other developing economies also held up relatively well. An underlying driver of exports in 2009 was an average 12.7% depreciation of the won relative to 2008 (Figure 3.11.4).

Second, manufacturing diversification over the past 20 years has reduced the former export dependence on a few product groups. Since the impact of the global crisis differed across product groups, this contributed to export resilience.

Private consumption was weak in early 2009 before picking up (Figure 3.11.5), to be little changed for the full year. The turnaround was most evident in durables and services. Consumer sentiment improved during the year, and, with an appreciating won, buoyant stock market, and rising housing prices, supported consumption, as did lower interest rates and tax cuts.

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Hit by the gloomy global economic outlook early in 2009, total fixed investment fell by 0.2% for the year, mainly because equipment investment dropped by 9.1%. As the year progressed, business confidence improved and average manufacturing capacity utilization rose (Figure 3.11.6). Construction investment grew by 4.4% in 2009 after a contraction of 2.8% in 2008. The turnaround was based on public works projects in the fiscal stimulus.

Aggressive monetary and fiscal easing, adopted as the global recession intensified, helped prop aggregate demand. The Bank of Korea cut its key policy interest rate six times from the beginning of October 2008 through February 2009 (Figure 3.11.7). In addition, the government provided liquidity support to the financial system.

The government brought forward a large part of its 2009 budget to the first half of the year. It also quickly adopted a sizable fiscal stimulus package. The 3-year (2008–2010) package amounts to around 6.5% of 2008 GDP, and contains a mix of tax cuts and additional spending. Tax cuts consist of both specific, temporary measures (such as tax incentives for replacing old automobiles, which had a big effect on automobile purchases and overall private consumption from the second quarter of 2009) as well as longer-term cuts in personal and corporate income taxes. Key areas for spending are public infrastructure, assistance for low-income groups, and job-creation initiatives. A 5.0% increase in government consumption and additional public works also supported domestic demand. The overall budget deficit widened from 2.0% in 2008 to 3.9% in 2009 as a result of fiscal easing.

Inflation slowed to 2.8% in 2009 from 4.7% in 2008, reflecting weak private demand and lower global oil and commodity prices. The impact of low economic growth was felt in the labor market, where the number of employed persons fell last year, though only by 71,000. While the labor market remained soft, the unemployment rate rose only modestly, from 3.2% to 3.6%, helped by the job-creation programs and women workers dropping out of the workforce.

A much steeper fall in the United States (US) dollar value of merchandise imports (25.7%) than in the value of merchandise exports (13.7%) produced a huge trade surplus, and led to a current account surplus equivalent to 5.1% of GDP.

**Economic prospects**

Strengthening domestic demand and a brightening global outlook point to the Korean recovery gathering momentum this year. Private consumption and investment are set to replace government spending and public works as the primary engines of domestic demand growth. Improving external conditions will also contribute significantly. In particular, the consolidation of recovery in industrial economies will broaden the scope of export recovery.

Korean manufactured exports such as automobiles, electronics, and capital goods tend to be highly sensitive to the global business cycle. Hence, after their earlier plunge, exports to industrial countries began to recover in the second half of 2009, a trend set to continue through 2010. Elsewhere, given projected acceleration of PRC growth and strong...
recovery in many other developing countries, exports to developing countries as a whole will remain robust.

In terms of export industries, the information technology (IT) product group—primarily semiconductors, liquid crystal displays, and mobile phones—will continue to play a leading role, underpinned by global demand recovery and competitive advantage in supply capacity and product innovation. Global demand for automobiles is projected to bounce back, fueled by demand expanding in the PRC and recovering in the US. Still, the outlook for petrochemical exports is clouded by the prospect of global supply outpacing global demand as a result of Middle Eastern production capacity coming online in mid-2010, while difficulties at global shipping companies are leading to delays and cancellations of orders, affecting Korean shipbuilders’ prospects. An expected increase in export unit prices brought about by higher prices for refined petroleum products and some IT products will have a positive effect.

On the downside, the won is projected to average around W1,100/$1 in 2010, which would be an appreciation of about 15% from 2009. The stronger won will hurt price competitiveness in global markets, but past experience suggests that the impact will be limited. Net exports will add to GDP growth in 2010, although by less than in 2009.

Private consumption is expected to increase by about 5%, with stronger growth in the first half reflecting the base effect from a sharp compression of consumption in the first half of 2009. The biggest impetus will come from strong growth in incomes as a result of expected large bonuses by corporations. Robust growth of gross national income, which adjusts GDP for terms of trade and so better reflects purchasing power, will also support consumption. Gross national income began to grow faster than GDP in the second quarter of 2009, owing to rising export unit prices of IT and some other products, and this is likely to persist to the end of 2010.

In light of favorable overall conditions, buoyant consumer confidence (Figure 3.11.8) is likely to persist this year. The won’s appreciation will boost household purchasing power by helping contain inflation. Against this, the tax incentives for replacing old automobiles ended in mid-2009, which will somewhat slow the momentum of consumption.

Total fixed investment is expected to grow by close to 10% in the first half of 2010 and by about 5% in the second. The primary cause will likely be a rebound in equipment investment. Growing by as much as 15% (again with a stronger first half, partly due to a low-base effect), this surge is underpinned by a rapid improvement in business confidence (Figure 3.11.8). Increased capacity utilization in manufacturing and rapid growth of industrial production will prompt companies to expand investment. Furthermore, the corporate sector is in good financial shape, due to improving profitability, and this is most evident in the IT sector, which accounts for about 30% of total investment.

At a broader level, the slowdown of global growth (relative to before the global recession) and persistent global overcapacity will constrain investment. Construction investment is projected to rise by 3% this year, a little weaker than in 2009. Public works will slow as the government unwinds its fiscal stimulus, but housing construction will pick up because
the government has eased some constraints on private housing supply and plans to continue to increase the supply of public housing.

The labor market picture is less benign. Government job-creation programs will be scaled back, while private sector hiring will be sluggish in light of the usual lag between growth and employment. A further constraint is weakness in the self-employed sector, which shed more than 300,000 workers in the third quarter of 2009. The number of employed persons is projected to rise by about 150,000, but unemployment will remain an area of concern.

The speed and scale of the exit from the monetary and fiscal stimulus will impinge on the recovery process, but are not expected to act as a serious drag on growth. The conducive environment for keeping inflation under control suggests that increases in the policy interest rate are likely to be small. The fiscal stimulus, which amounted to W38.8 trillion or 3.6% of GDP in 2009, will be scaled back to W17.2 trillion, or 1.7% of GDP, in 2010. As a result, the fiscal deficit is expected to narrow from 3.9% in 2009 to about 3% in 2010.

Taking all these factors into account, GDP growth for 2010 is projected to climb to 5.2% (Figure 3.11.9). This above-trend performance, largely driven by the low-base effect of 2008 and 2009, will mostly close the wide output gap that opened when growth slumped in those years. GDP growth is forecast to ease to a still-high 4.6% in 2011, as the pace of equipment investment slows from this year’s exceptionally high rate.

Inflation is projected to hover around 3.0% in the forecast period, within the central bank’s 2%–4% target band. The stronger won will help contain import prices, and an output gap persists in the economy. These factors are likely to offset the inflation impact of higher oil prices.

In the external accounts, merchandise exports in US dollar terms are projected to grow by about 12% this year, whereas merchandise imports, driven by stronger domestic demand and higher oil and commodity prices, will grow by about 20%. The current account surplus will shrink from its record high in 2009 to the equivalent of about 1.5% of GDP and then to 1.0% in 2011.

Slower and weaker than expected recovery among industrial countries is the main downside risk to the forecasts, given Korea’s openness to trade and financial flows. The primary domestic downside risk is the structural problem of high household debt. The ratio of personal debt to personal disposable income has reached about 150%, and is much higher among low-income households. However, various mortgage-related risk-management measures imposed on banks and nonbank financial institutions should retard the growth of mortgage-dominated household loans.

Overall, the positives outweigh the negatives, and growth may surprise on the upside again, as hinted at by recent trends in a key leading indicator (producers’ shipments to inventories—Figure 3.11.10).

**Development challenges**

Creating a better working environment for women and accelerating the transition to an economy based on productivity improvements (Box 3.11.1) are two medium-term policy challenges.
Improving the working environment for women has become more pressing in light of prospective labor shortages due to rapid population aging and low fertility in Korea. The global recession highlighted this point: its impact on the Korean labor market was much more pronounced for women than men (Figure 3.11.11). Women tend to land less stable first jobs than men, including a large share of nonwage and temporary-contract wage jobs, so were more vulnerable when the economy turned down. Finally, of women who left their employment, among the core working-age groups—the 30s–50s—a large majority dropped out of the labor force altogether, with child raising and household work the dominant reasons.

As well as leaving the workforce, too many women do not join it. For example in 2007, the employment rate among female university graduates was nearly 20 percentage points below the average of countries in the Organisation for Economic Co-operation and Development. Using the female workforce more efficiently could bring significant benefits for the economy and the women involved. Indeed, rapid population aging and the consequent prospective reduction of the labor force make full use of female workers, especially highly skilled ones, even more important.

3.11.1 Raising Korea’s potential growth rate

As the global recession recedes, an issue that will come back to center stage is: What is Korea’s longer-term potential growth rate—the economy’s aggregate supply capacity—and what are the policy options to boost it?

Korea’s GDP growth has slowed since the early 1970s, from an average of 10.3% in 1971–1979 to 4.9% in 2000–2008. Potential GDP growth has also declined (Box figure).

Broadly, the deceleration of potential growth reflects a slowing in the accumulation of capital and in the growth of the labor force. The growth of the working-age population fell sharply from 2.4% in 1980–1989 to 1.2% in 1998–2008. The growth of equipment investment slowed from 8.7% in 1991–1997 to 4.8% in 1998–2008. Technological progress and other productivity improvements have been insufficient to significantly offset the decline in growth due to slower factor accumulation. Research and development (R&D) expenditures have risen rapidly, but their size is not enough (3.5% of GNP in 2007) to have a notable positive effect on economywide efficiency.

In the coming years, rapid population aging, lack of competitiveness in knowledge-based industries, and the catch-up of latecomers, such as the People’s Republic of China, in Korea’s main industries all point to clear limits to growth.

Still, Korean policy makers have a range of options to accelerate the transition from a growth model based on factor accumulation to one based on productivity improvements. Here, the broad thrust should be to promote the acquisition of capital goods that embody new technology and the accumulation of highly skilled human capital for high-tech industries and knowledge-based service industries.

For example, the government could consider providing fiscal incentives for hiring older and female workers to lessen the impact of the decline in the working-age population and expanding its R&D support to communications, finance, and other service industries. Services, which lag manufacturing in productivity, would benefit from an easing of regulations that constrain the entry of new competitors. Such measures would help raise potential growth.