

Republic of Korea

Buoyed by robust domestic demand, growth picked up in the second half of 2007. Both private consumption and investment recorded solid gains. With business and consumer confidence rising, the economy is projected to maintain growth of around 5% this year and next. Continued strength of domestic demand is expected to offset weakness of external demand. Inflation will accelerate, but remain within the central bank's target band.

Economic performance

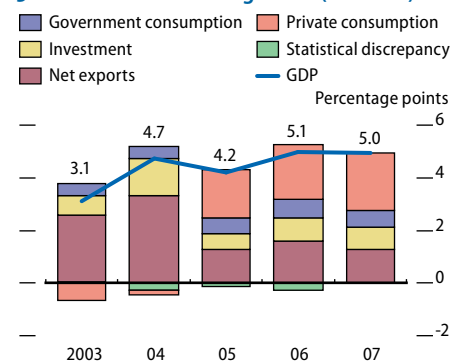
Powered principally by domestic demand, GDP grew by 5.0% in the Republic of Korea (hereafter Korea) in 2007, above the 5-year average of 4.8% in 2002–2006. Quarterly growth accelerated from 4.0% (year on year) in the first quarter to 5.7% in the fourth. Domestic demand accounted for around 75% of total GDP growth and net exports 25% (Figure 3.11.1). Within domestic demand, both private consumption and private investment made solid contributions to the economic expansion.

Growth in private consumption was 4.5% (Figure 3.11.2), led by purchases of household appliances, personal computers, and other durables. Consumer surveys by the Bank of Korea show that consumer confidence gained over the course of the year, and this was reflected in an acceleration in private spending into the fourth quarter. Consumer confidence was boosted by rising real wages and by a strong stock market—the Kospi index surged by around 30% in both local currency and United States (US) dollar terms.

Capital investment growth of 4.0% marked its fastest pace since 2003 (Figure 3.11.3). Investment was spurred by the robust expansion in both private consumption and exports. Corporate investment in plant and equipment climbed by 11% in the first half, partly a result of one-time factors, including the replacement of banks' automated teller machines because of the introduction of new currency notes. It then slowed in the second half, leaving growth for the full year at a solid 7.6%. Outlays on semiconductor-making machinery and precision machinery, along with transport equipment, were the key drivers of corporate investment. Construction investment grew by 1.2%, returning to positive territory for the first time in 3 years. The house price boom of recent years faded in 2007, with average house prices rising by a meager 2%.

The benign global economic environment through most of 2007 and enhanced labor productivity in manufacturing supported merchandise exports, which grew by 14.1% in nominal US dollar terms. Strong demand for Korean exports from the People's Republic of China (PRC), European Union, and Middle East more than offset a slowdown in exports to the

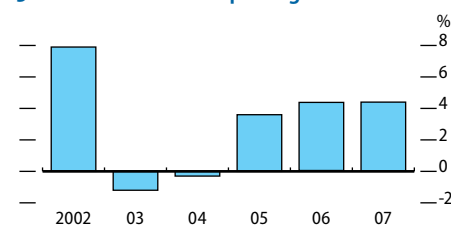
3.11.1 Contributions to growth (demand)



Source: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 27 March 2008.

[Click here for figure data](#)

3.11.2 Private consumption growth



Source: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 27 March 2008.

[Click here for figure data](#)

US in the second half. Exports of steel products and general machinery grew especially fast, while automobiles, semiconductors, and wireless communications equipment also maintained their export momentum. Merchandise imports rose by 15.3%. A healthy merchandise trade surplus helped produce a current account surplus estimated at 0.6% of GDP, despite a widening deficit in services trade. The financial account also posted a substantial surplus even with sizable net outflows of foreign direct and portfolio investment, owing to heavy short-term external borrowing by banks.

Labor market conditions remained broadly favorable. The unemployment rate averaged 3.2%, down from 3.5% in 2006, and real wages rose by 2.9%. New legislation that made it less attractive to hire temporary workers came into effect on 1 July 2007. Partly as a result, the number of workers on permanent contracts rose by about 400,000 during 2007. The greater sense of job security bolstered consumer confidence, although the labor market may lose some flexibility in the longer run. About 282,000 jobs were created in 2007, mainly in services, but jobs were shed in manufacturing as companies continued to relocate abroad and outsource work.

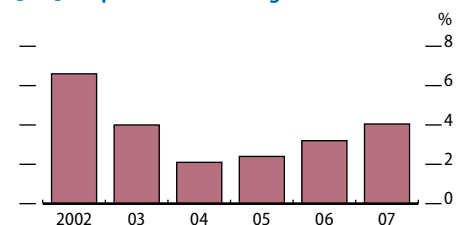
An acceleration in inflation was the main concern last year. Although it averaged a subdued 2.5%, the rate of price increases quickened from 2.1% in the first quarter to 3.3% in the fourth. Rising prices for imported oil was one reason. The strengthening of domestic demand also contributed, as did a second-half weakening of the won against the yen. Appreciation of the won against the US dollar, though, helped limit inflation pressure (Figure 3.11.4). This appreciation marks a continuation of a trend that began in 1998 (Box 3.11.1). The Bank of Korea further tightened monetary policy in response to the inflation pressure. As a result, bank lending interest rates have nudged up over the past 2 years.

Economic prospects

The upward momentum of the second half of 2007 is projected to continue in the first half of 2008, but taper off later in the year. The broad-based nature of the upswing, and the fact that it is based on domestic demand, suggest that it should survive the likely global slowdown. Although exports have remained strong so far, the global slowdown is likely to take its toll on them during the course of the year.

A critical assumption is that the newly elected Government that took office in February 2008 will spur further increases in business and consumer confidence. Indexes of both held up going into 2008 (Figure 3.11.5), despite a deteriorating global outlook. Business groups expect that the new administration will act on deregulation, privatization, and financial reforms. The Government has proposed to cut the corporate income tax rate from 25% to 20% over 5 years; one of the stated aims of the tax cut is to attract more foreign firms to Korea. It has also pledged to cut red tape for small and medium enterprises and provide them with more support. Such policies suggest that the efforts to encourage growth should benefit the broader businesses community, in addition to the large conglomerates. Another policy proposal is some large-scale public

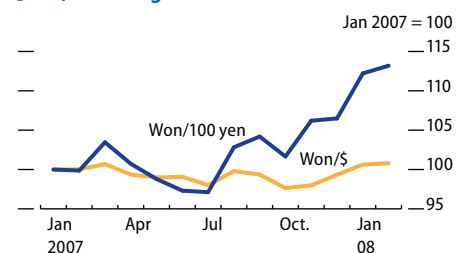
3.11.3 Capital investment growth



Source: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 27 March 2008.

[Click here for figure data](#)

3.11.4 Exchange rate index



Source: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 3 March 2008.

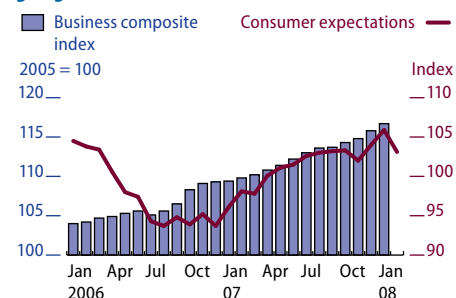
[Click here for figure data](#)

3.11.1 Selected economic indicators

	2008	2009
GDP growth	5.0	5.2
Inflation	3.4	3.0
Current account balance (% of GDP)	-0.2	-0.5

Source: Staff estimates.

3.11.5 Confidence indicators



Source: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 10 March 2008.

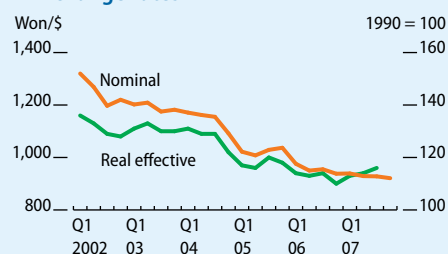
[Click here for figure data](#)

3.11.1 Flexible exchange rates and export performance: Recent experience

Prior to the Asian financial crisis of 1997–98, most East and Southeast Asian countries pegged their currencies to the US dollar. Many economists believe that fixed exchange rates contributed to the crisis by creating a false illusion of zero exchange rate risk among investors. Reflecting this concern, the International Monetary Fund advocated more flexible exchange rates in the aftermath of the crisis. Indeed, exchange rates of these countries have generally become more flexible against the US dollar. Greater flexibility has often been accompanied by substantial appreciation against that currency, a trend that has been especially evident in the case of Korea.

The rise of the won is particularly striking since the first quarter of 2002 (Box figure 1), since when the won has risen by around 40% against the dollar, without any major interruption. Trends in the nominal won-dollar exchange

1 Exchange rates



Sources: Bank of Korea, available: http://ecos.bok.or.kr/Elindex_en.jsp, downloaded 29 February 2008; staff calculations.

[Click here for figure data](#)

rate can differ from trends in the real effective exchange rate (REER). The REER incorporates the exchange rates and prices of all Korea's major trading partners, and is therefore a more comprehensive measure. The REER appreciated by about 15% between the first quarter of 2002

and the third quarter of 2007.

National authorities usually worry that an appreciation of their currency will lead to a loss of export competitiveness. Yet the period of Korea's currency appreciation has been characterized by a rapid surge of exports (Box figure 2). One factor stands out as an explanation—the exceptionally robust world economy

2 Real exports



Source: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/Elindex_en.jsp, downloaded 3 March 2008.

[Click here for figure data](#)

of 2002–2007. In particular, soaring demand from fast-growing emerging markets such as the People's Republic of China, Middle East, and Russian Federation has helped propel Korean exports of manufactured products. Improved labor productivity in manufacturing has also helped Korean exporters cope well with a rising won. This is especially true for producers of intermediate and capital goods.

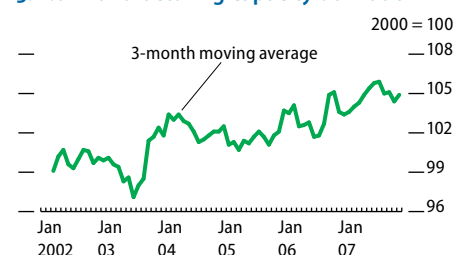
The main lesson from the Korean experience for other Asian countries seems to be that continually improving competitiveness is the only sustainable source of export growth that can withstand swings in the global business cycle.

construction projects. Whatever their long-term economic logic, the projects would bolster construction in the near term.

Rising consumer confidence, underpinned by favorable labor market conditions and the improvement in household incomes, will likely support further growth in private consumption. An upward adjustment in tax brackets from January 2008, which effectively reduces personal income taxes, provides further support for consumption spending. Sales of consumer durables are likely to benefit: televisions for the Beijing Olympics in August and cars from an unusually large number of new models on the market this year from Korean manufacturers. These positive factors are expected to outweigh the negative factors of rising inflation and interest rates.

Investment is also expected to show healthy growth in 2008. Corporate spending on plant and equipment will grow on the back of strong private consumption. A high rate of manufacturing capacity

3.11.6 Manufacturing capacity utilization



Source: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/Elindex_en.jsp, downloaded 27 February 2008.

[Click here for figure data](#)

utilization (Figure 3.11.6 above) will also induce companies to invest in plant and equipment. Against this, the uncertain global economic environment will damp export-oriented investment. Construction is expected to accelerate due to a recovery of nonresidential construction and planned expansion of government construction projects. At the same time, the stagnation of housing prices (Figure 3.11.7) might limit residential construction activity, given that capital gains are an important motivation in demand for new housing.

The projected weakening in demand in major industrial countries for electronics and other manufactures will restrain export growth, although that will be somewhat cushioned by expected continuing robust sales to the PRC and other developing nations. High global oil prices will hurt, too. Taking these factors into account, GDP growth is forecast at 5.0% in 2008, edging up to 5.2% in 2009 if external demand picks up as expected (Figure 3.11.8). Data available for the start of 2008 point to solid growth in industrial production and services activity in January, as well as an unexpected surge in merchandise exports that month (up 15.1%) and February (up 18.8%). A contraction of exports to the EU and US was more than compensated by strong exports to the PRC, Middle East, Russian Federation, and other emerging markets. Imports jumped by about 30% in these 2 months.

Inflation will continue to be a concern. Its acceleration last year is likely to continue in the first half of 2008 because of strong domestic demand and high oil prices. Faster inflation in the PRC is raising concerns in Korea, in light of the country's heavy import dependence on PRC consumer goods. In the first 2 months of 2008, inflation accelerated to average 3.8%. For the full year, it is likely to average 3.4% (Figure 3.11.9), which would be just within the 3.5% upper limit of the Bank of Korea's inflation target band.

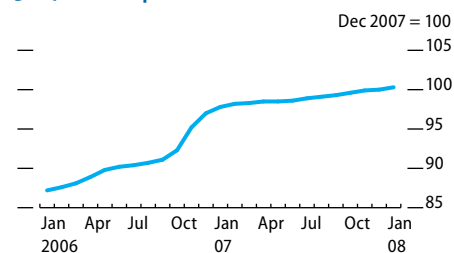
Containing inflation will be the focus of monetary policy, and the central bank could tighten further. Tightening so far has been partly to control liquidity, which has risen sharply since the second half of 2006. However, weaker global economic conditions will likely limit the extent of any rate increases. Fiscal policy is expected to remain broadly neutral in 2008. The proposal for large public construction projects involves using private capital for part of the funding. Import growth is projected to exceed export growth owing to the relatively strong domestic demand and the increased price of imported oil, leading to small current account deficits this year and next (Figure 3.11.10).

The main risk to the outlook is a deeper than expected downturn in the global economy, which would hit Korea's exports and manufacturing industries hard.

Development challenges

Falling fertility and rising life expectancy have given Korea a rapidly aging population. Foremost among the challenges this presents is the provision of adequate support for the elderly. On current demographic trends, the old-age dependency ratio (the ratio of the population aged 65 or more to the population aged 15–64) is projected to reach 65% by 2050 (Figure 3.11.11), making Korea one of the oldest countries in the

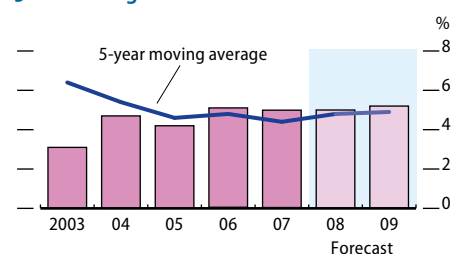
3.11.7 House price index



Source: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 5 March 2008.

[Click here for figure data](#)

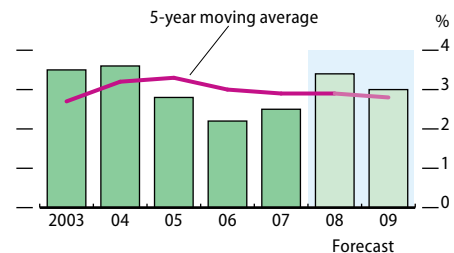
3.11.8 GDP growth



Sources: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 27 March 2008; staff estimates.

[Click here for figure data](#)

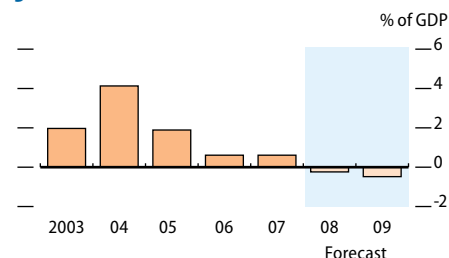
3.11.9 Inflation



Sources: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 3 March 2008; staff estimates.

[Click here for figure data](#)

3.11.10 Current account balance



Sources: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 1 February 2008; staff estimates.

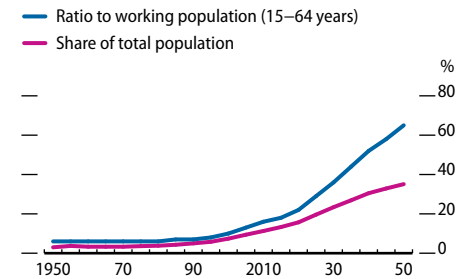
[Click here for figure data](#)

world. This has stark implications about the ability and willingness of the employed to support retirees in the future.

The centerpiece of the pension system—the National Pension Scheme (NPS)—was set up in 1988. It covers workers in the private sector, and equal contributions are made by employers and employees. NPS is wholly state managed and its funds are currently invested almost entirely in domestic financial assets. Demographic realities necessitated cuts in pension benefits and increases in contributions in both 1998 and 2007. Legislative passage of the second of these reforms took 3 years, illustrating the difficulty of reaching agreement on pension reform. Furthermore, while cutting benefits enhances sustainability of NPS, it compromises its ability to deliver adequate pensions.

Political leadership is needed to raise awareness of the urgency of pension reform. While adjustments of parameters such as contribution rates are a step in the right direction, they fail to address the issue of long-term solvency of NPS. More fundamental pension reform that directly strengthens sustainability and adequacy in the face of current demographic trends calls for bolder strategies. For example, in the long run, moving from the current partially funded pay-as-you-go system to a fully funded system would benefit both sustainability and adequacy.

3.11.11 Old-age indicators



Sources: Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, *World Population Prospects: The 2006 Revision* and *World Urbanization Prospects: The 2005 Revision*, both available and downloaded from <http://esa.un.org/unpp>, 10 January 2008.

[Click here for figure data](#)