

Republic of Korea

Growth accelerated to its fastest rate in 4 years in 2006, spurred by a recovery in domestic demand and strong exports, though momentum slowed over the course of the year. In 2007, a continued expansion in investment, particularly in manufacturing, and a recovery in construction are likely to underpin a rebound in domestic demand over the year. The strength of the rebound will depend on a continued recovery in consumption. Growth in exports is likely to ease, trimming the expansion in GDP for the whole year. Structural reforms at the moment are incomplete, particularly in services, capping growth potential.

Economic performance

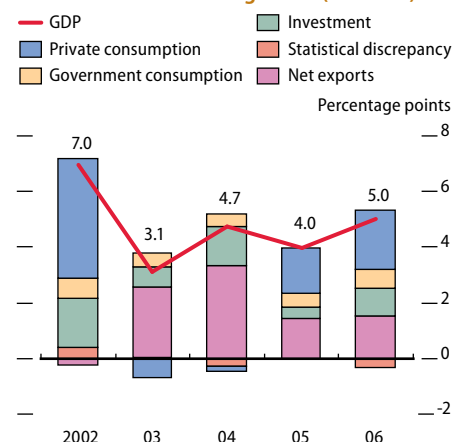
GDP grew by 5.0% in 2006 in the Republic of Korea (hereafter Korea), a marked improvement from the prior year's 4.0%. This outturn masks, though, decelerating momentum over the course of the year amid some softening in growth of both exports and domestic consumption. Quarterly GDP growth rates slid from 6.1% (year on year) in the first quarter to 4.0% in the fourth. After peaking in the first quarter, industrial production eased and inventories accumulated. A cooling in the housing market early in the year hurt construction investment and consumption spending throughout the summer months. Although buoyant exports continued to support a recovery in nonconstruction investment, domestic demand weakened over the year as a whole.

Private consumption posted healthy growth of 4.2% in 2006, the highest rate since the credit card crisis in 2003, when a sharp increase in card issuance resulted in a surge in household debt and a subsequent spending slump. Here too, quarterly growth rates slipped over the year, partly because of a renewed buildup in household debt. Despite extensive government efforts to cool a buoyant residential property market, house prices accelerated in the second half of the year. This resurgence, in an environment of relatively low interest rates and ample liquidity, prompted households to borrow more to finance home purchases. Household debt rose to nearly 67% of GDP by September 2006, from 65% in 2005, and is up sharply from about 40% a decade ago.

The economic recovery broadened with a pickup in capital investment. Capital spending increased by 3.2%, despite a shrinkage in construction investment in the first half of the year. Rising house prices lifted construction in the second half. Corporate spending on machinery and equipment made a steady recovery, increasing by 7.5% during the year. Total investment contributed 1.0 percentage point to overall GDP growth (Figure 2.10.1). Given that many large companies are export-oriented, robust export performance and strong balance sheets augur well for a continued investment recovery.

Merchandise exports rose by 14.4% in nominal US dollar terms in 2006, in the face of a strengthening won, a muted recovery in global

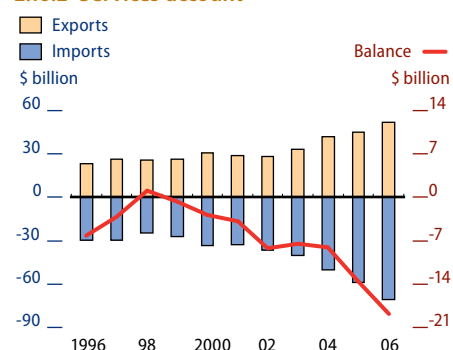
2.10.1 Contributions to growth (demand)



Source: Bank of Korea, Economic Statistics System, available: http://ecos.bok.or.kr/ElIndex_en.jsp, downloaded 26 January 2007.

[Click here for figure data](#)

2.10.2 Services account



Source: Bank of Korea, Economic Statistics System, available: http://ecos.bok.or.kr/ElIndex_en.jsp, downloaded 18 February 2007.

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information technology activity, and high oil prices. Automobiles, consumer electronics, semiconductors, and ships continued to lead Korea's exports. Generally benign external demand conditions and improved large-company competitiveness underpinned the robust export performance in these industries. Even faster growth in imports (up 18.4%) compressed the trade surplus. High prices for oil and raw materials lifted the import bill in most of 2006, though signs of moderation appeared in the fourth quarter. Merchandise trade still posted a significant surplus, but it was largely offset by a widening gap in services trade. The services deficit more than doubled between 2004 and 2006, to \$18.8 billion, as more Koreans opted for overseas education, vacations, and other services (Figure 2.10.2). Productivity growth in a number of domestic services has stagnated (Figure 2.10.3), in part owing to a pervasive public-sector presence in the sector and also to restrictions on international firms operating in some services areas, which limits competition.

The pickup in economic growth led to some strengthening of the labor market, and for the year unemployment averaged 3.5%, down from 3.7% in 2005. Average monthly earnings rose by 2.6%. However, while 2006 saw 295,000 new jobs, the economy is generally sluggish at creating employment, even during upturns. Rising labor costs have encouraged manufacturers to relocate production overseas or to outsource parts of their production to countries with cheaper labor.

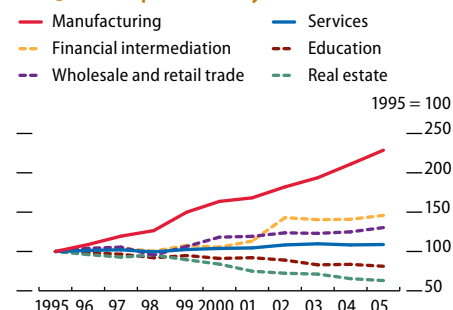
Another barrier to creating more jobs is structural rigidity in the labor market. After years of labor union action, employees in jobs classified as permanent positions have gained strong legal protection for job security, improved working conditions, and higher wages. Employers increasingly have turned to workers they can hire on fixed-term contracts, often at lower overall compensation. Government efforts to contain the trend toward fixed-term employment could result in companies being more reluctant to hire, unless permanent workers agree to give up some of their existing benefits.

Consumer price inflation decelerated by a half percentage point to 2.2% in 2006. The easing of global oil prices from their peaks in 2006 and a stabilizing of food prices helped, and monetary tightening over 2 years also took effect. The won appreciated against both the US dollar and the yen from already strong levels, also helping keep a lid on inflation (Figure 2.10.4). Surpluses in both the current and capital accounts have underpinned the currency's strength. Despite significant capital outflows of portfolio investment, the capital account posted a large surplus due to a sharp increase in short-term borrowing by banks for the purposes of export industries' currency hedging. The pressure on the currency to appreciate appears to be easing though, as export growth moderates and as Koreans are allowed to invest more overseas.

Economic prospects

Growth is expected to pick up again from late-2006 levels on the back of a steady increase in investment and continuing support from exports, as well as a gradual consumption recovery in 2007. Although annual growth is projected to slow to 4.5% (Figure 2.10.5), quarterly economic performance is likely to accelerate over the year. The recovery will

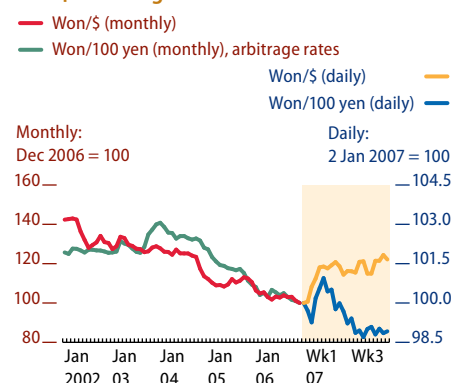
2.10.3 Labor productivity



Source: Staff estimates based on employment data from International Labour Organization and gross value added from Bank of Korea.

[Click here for figure data](#)

2.10.4 Exchange rate index



Source: Bank of Korea, Economic Statistics System, available: http://ecos.bok.or.kr/Elndex_en.jsp, downloaded 6 February 2007.

[Click here for figure data](#)

2.10.1 Selected economic indicators

	2007	2008
GDP growth	4.5	4.8
Inflation	2.4	2.6
Current account balance (% of GDP)	0.1	0.1

Source: Staff estimates.

2.10.1 Dangers of the house price boom

Surging housing prices have raised concerns in the Government that a bubble may form, which ultimately could damage the economy. At this stage, there are fundamental reasons behind the price gains: an underlying housing supply shortage and strong demand underpinned by low borrowing costs. The house price/rental value ratio—its historic average may be used as proxy for property values—also remains low for the country overall, even though home prices have been rising much faster than rental values over the past few years (Box figure 1). Nevertheless, the pace of increase in house prices in some affluent areas of Seoul has been alarming, rising by nearly 25% between September 2005 and September 2006.

Key concerns are the rapid buildup in household debt associated with mortgage lending and its possible knock-on effects. Fast-rising house prices and expectations of further gains have encouraged households to take on more mortgage debt. For example, bank lending to households increased by 10.7% in the 12 months to September 2006, with more than 60% of this mortgage related. As household debt has grown much faster than incomes, households' ability to repay debt has deteriorated: the ratio of household debt to income has resumed its rise since 2005 (Box figure 2) and the number of personal bankruptcies has more than doubled in this period.

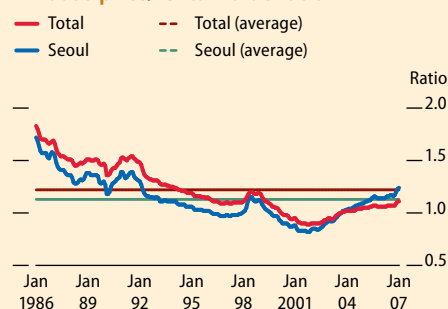
Heavy household debt burdens have also hurt prospects for a speedy recovery in consumer spending. A sharp downturn in house prices could push financially weak households into bankruptcy, starting another prolonged slump in private consumption, and threaten the health of the financial system by eroding loan collateral values and swelling the number of delinquent loans. For now, though, bank stability indicators show little sign of stress.

The Government introduced another set of measures in November 2006 in an effort to stabilize house prices, the eighth such package in 3 years. These latest measures include plans to increase the housing supply, which has

not been a focus of previous packages. They also involve tighter financial regulations to curtail growth of household borrowing.

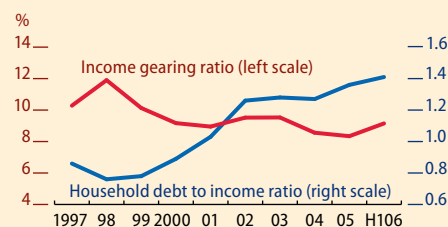
A major policy challenge is to ensure sufficient housing supply by addressing inefficiencies arising from heavy public sector involvement and regulation of the housing market, and by securing adequate public provision of housing for low-income earners, who may be bypassed in the market mechanism. But there is always a risk that measures taken to contain price rises could in themselves precipitate a sharp fall in housing prices.

1 House price/rental value ratio



Source: Staff estimates based on housing price data from Bank of Korea, Economic Statistics System.

2 Household debt and income



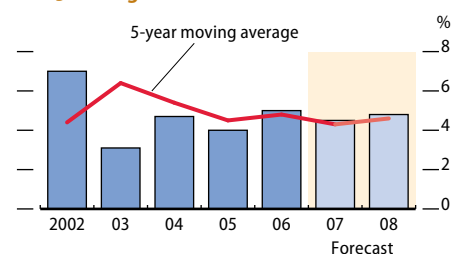
Note: Income gearing ratio refers to the share of household interest payments in household disposable income.

Sources: Household Assets and Debts: Flow of Funds Statistics, Bank of Korea; Household Disposable Income: System of National Accounts, Bank of Korea.

broaden with domestic demand strengthening. Economic indicators in late 2006 showed signs of a stabilization in industrial production, construction investment, and consumption. As 2007 progresses, the external environment could turn more favorable with the global downturn bottoming in the second half. The Korean economy is projected to continue building momentum in 2008, based largely on firming domestic demand, with growth of 4.8% that year.

Private consumption is recovering, as the improvement in the job market underpins growth in household incomes. However, household debt remains high at a time when increases in interest rates in 2005–2006 are adding pressure on consumer spending. Given the underlying weakness in household balance sheets, private consumption growth

2.10.5 GDP growth



Sources: Bank of Korea, Economic Statistics System, available: http://ecos.bok.or.kr/ElIndex_en.jsp, downloaded 26 January 2007; staff estimates.

[Click here for figure data](#)

is expected to remain moderate. Moreover, consumer sentiment has declined (Figure 2.10.6) because of concerns about the global economic outlook, uncertainty surrounding the implementation of new tax laws targeting real estate, and political tensions involving the Democratic People's Republic of Korea.

Export-led manufacturing firms are for the most part in good shape, with strong profits, to continue an expansionary cycle in investment. Capacity utilization has edged up too, indicating a potential need for expanding production facilities (Figure 2.10.7). The upturn in house prices in the second half of 2006 is likely to be followed by a pickup in housing construction over the forecast period, helped by new measures from the Government to increase housing supply.

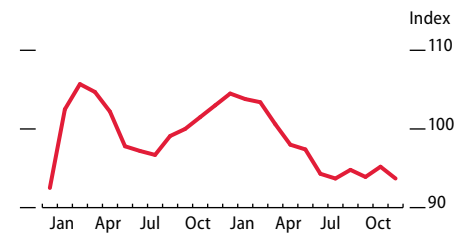
In 2007, the expected moderate slowdown in the US economy suggests there will be some easing in Korea's export growth rate. Nevertheless, a still-robust export performance will support a recovery in industrial production and business spending. However, rapidly rising imports, driven in part by demand for overseas travel and education, will cut by half the contribution of net exports to GDP growth. Although merchandise trade looks set to achieve a record surplus, based on the robust exports and declining oil and commodity prices, growth in imported services will remain high. The current account surplus, which narrowed to less than 1% of GDP last year, is projected to shrink further (Figure 2.10.8).

Monetary and fiscal policies are projected to be set in generally neutral positions. The Bank of Korea is expected to loosen the tightening bias that it maintained throughout 2006, as inflationary pressures subside in a context of softening economic growth and declining import prices. Consumer price inflation is likely to remain below the central bank's target band of 2.5–3.5% in 2007 (Figure 2.10.9). On the fiscal front, an expected increase in tax revenues, drawing on last year's stronger economic growth, should make room for some additional fiscal outlays this year. Fiscal spending will continue to focus on strengthening social infrastructure and the social safety net, on enhancing productivity in the services sector, and hence on preparing for long-term structural changes including an aging society. However, growing concerns both about long-term fiscal sustainability caused by the aging population and about the projected costs of social services will restrain the use of expansionary budgets.

New tax laws take effect in 2007 intended to streamline sources of tax revenues and restore fairness by removing some of the wide array of tax credits and deductibles. A fiscal tightening effect from efforts to broaden the tax base and to strengthen tax collection has been balanced by measures to leave in place a majority of tax credits for small and medium enterprises (SMEs) and for business investment for the time being, given that economic activity will slow in 2007 relative to 2006.

Risks to the projections would most likely originate in any sharp slump in the US economy, which would undermine Korea's export performance and reduce GDP growth. Domestically, a surge in housing prices has led to an increase in household mortgage debt. A significant downturn in the housing market could intensify financial pressures on households, which would retard the recovery in consumption spending (Box 2.10.1).

2.10.6 Consumer expectations index



Source: Bank of Korea, Economic Statistics System, available: http://ecos.bok.or.kr/ElIndex_en.jsp, downloaded 10 January 2007.

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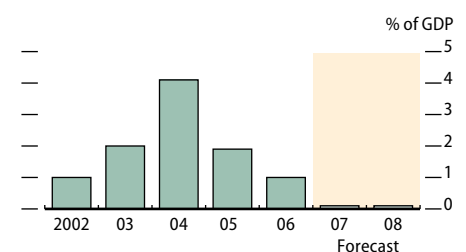
2.10.7 Manufacturing capacity utilization (3-month moving average)



Source: National Statistical Office, available: <http://www.kosis.nso.go.kr>, downloaded 5 February 2007.

[Click here for figure data](#)

2.10.8 Current account balance



Sources: Bank of Korea, Economic Statistics System, available: http://ecos.bok.or.kr/ElIndex_en.jsp, downloaded 18 February 2007; staff estimates.

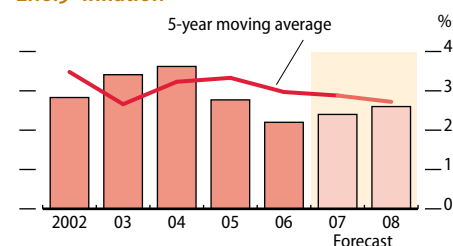
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Development challenges

Korea faces important challenges resulting from intense global competition and an aging population. The recovery in GDP growth rates after the 1997–98 Asian financial crisis partly reflects successes in addressing certain structural weaknesses in the economic and financial framework. Reforms are incomplete though, as illustrated by the 2003 credit card crisis and the subsequent prolonged slump in private consumption. A more fundamental problem that is damping private consumption is lagging productivity in the services sector and among SMEs. This is holding back improvements in the labor market and in wages growth. The likely key to resuming rapid growth over the medium term is to accelerate productivity growth by continuing with structural reform, particularly in the labor market and in the services sector, including SME restructuring.

As the economy matures and as the population ages, slowing labor and capital inputs will require a more efficient and flexible economic structure that can ensure productivity gains while accommodating the necessary socioeconomic adjustments. In the medium to long term, reforms should focus on health, education, and facilities for the aged; undue regulatory burdens; and weaknesses in the services sector.

2.10.9 Inflation



Sources: Bank of Korea, Economic Statistics System, available: http://ecos.bok.or.kr/Elndex_en.jsp, downloaded 24 January 2007; staff estimates.

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