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Robust economic recovery continued through 2010, when a strong export performance and healthy domestic demand underpinned the steepest rise in GDP for nearly a decade. Growth is expected to moderate to a more sustainable pace in 2011. The paramount near-term challenge is to contain emerging inflation pressures. A key development challenge is to create more job opportunities for those seeking work.

Economic performance

Economic recovery gained traction in 2010 in the Republic of Korea, as GDP rose by 6.1%, the sharpest increase since 2002. The exceptional growth largely reflects a rebound from below-trend growth of 2.3% in 2008 and 0.2% in 2009. The recovery was broad-based and rested on both external and domestic drivers. Externally, exports surged in tandem with the rebound in the world economy and trade. Domestically, private demand replaced fiscal and monetary policy stimulus pushed through during the global recession. Figure 3.11.1 shows the trajectory of quarterly growth during 2008–2010.

Among the different sources of growth in 2010, robust investment played the dominant role, accounting for over two-thirds of the year’s expansion (Figure 3.11.2). Surging exports of manufactured goods drove the sharp rise in investment. Private consumption accounted for the rest of GDP growth. Government consumption contributed less than a tenth, mirroring the transformation from policy-led recovery to growth based on private demand. The impact on GDP of the stronger total demand was partly offset by a surge in imports of goods and services.

As global trade volume swung from sharp contraction in 2009 to expansion in 2010, it propelled a 29.6% rise in merchandise exports in US dollar terms. Export performance was strong throughout the year (Figure 3.11.1). Information technology-related products such as semiconductors and liquid crystal displays performed particularly well. Exports of autos, auto parts, and general machinery also grew rapidly. In terms of export destinations, demand from the People’s Republic of China (PRC) and Southeast Asia drove growth in the first half and held up well in the second. Demand from Japan and the United States also picked up last year from 2009.

Mirroring the strong recovery of demand, imports rose sharply by 31.9%. The merchandise trade surplus rose to about $42 billion, but the deficit in services trade nearly doubled to $11 billion. The current account surplus fell to 2.8% of GDP, from 3.9% in 2009.

An outstanding feature of growth in 2010 was the acceleration of equipment investment, which soared by 24.5%, though it partly reflects a base effect from 2009, when such investment fell by 9.1%. Companies

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in export-oriented industries regained their appetite for investment as global demand for their products recovered. Companies were also spurred to expand facilities by a rise in manufacturing capacity utilization from an average of 74.6% in 2009 to 81.8% in 2010 (Figure 3.11.3). Further, an appreciating won against the US dollar in the second half of the year lowered the cost of imported capital goods. Imports of machinery rose sharply, although those of transport equipment grew much less quickly.

Construction investment contracted by 2.3% in 2010, after growing by 4.4% in 2009 on the back of public works. The weakness in construction reflected a sluggish housing market, where the inventory of unsold housing continued to build.

Private consumption bounced back (Figure 3.11.4) to grow by 4.1% in 2010, after feeble growth in 2009, supported by a stronger labor market. Employment rose by 323,000, even as the government scaled back job creation programs. Real wages increased by more than 3%, after contracting by 6% in 2009. Gross domestic income rose by 5.8%, the fastest pace in 8 years. An upturn in the stock market and appreciation of the won contributed to stronger consumer sentiment.

The unemployment rate nudged up to 3.7% from 3.6% in 2009, mainly a result of more Koreans looking for work in light of the improved outlook.

In terms of economic sectors, manufacturing stood out with a 14.6% increase in production last year, fueled by surging export demand. Services expanded by a healthy 3.5%.

Despite the strong economic growth, average inflation rose only slightly in 2010, to average 2.9%, within the Bank of Korea’s target band of 2.0%–4.0%. As economic recovery gained traction, the central bank started to edge up its policy interest rate from the record low 2.0% set during the global recession. From July 2010 to March 2011, the Bank of Korea raised the rate in four steps to 3.0%.

**Economic prospects**

Exceptionally strong growth in 2010 was based to a large extent on a one-time base effect due to weak performance of 2009. Consequently, the economy is expected to decelerate this year to more sustainable levels around the potential growth rate, estimated at 4.3%–4.9%. A generally benign global outlook will support exports and healthy private investment, and consumption will underpin growth. The consolidation of growth and the emergence of inflation pressures mean that inflation is set to replace growth as the priority of policy makers.

Merchandise exports are projected to grow by more than 10% in 2011. Demand from industrial economies will likely be subdued, but developing countries are forecast to grow rapidly and provide a more certain source of demand. The country has diversified its export markets in recent years, with the PRC in particular providing an important export market during the global recession (Figure 3.11.5).

Exports to the PRC have traditionally been dominated by high-tech parts and components for assembly and reexport to industrialized countries. Increasingly, however, the PRC is becoming a direct consumer of final goods, which helps to explain why the Republic of Korea’s exports to that market held up so well in 2009–2010.
Still, several factors will damp growth in exports in 2011. First, the country’s exports, especially durables and capital goods, are sensitive to the global business cycle, so the expected easing in world trade growth will act as a drag on exports. After past global downturns, exports initially responded elastically to the recovery of global growth, but lost some momentum as recovery moderated.

Other constraining factors for growth are an expected appreciation of the won and likely weakness in unit prices of exports. (Foreign competitors have expanded production capacity for semiconductors, liquid crystal displays, and other key items, which sets an upper bound to their prices.)

On the domestic front, strong consumer and business confidence will buttress growth in private consumption and investment (Figure 3.11.6). High corporate profits in 2010 and prospective foreign capital inflows have enabled firms to invest. However, as pent-up demand for investment postponed during the global slump was largely satisfied in 2010, equipment investment is likely to moderate to a more sustainable level of about 8% this year.

Construction investment will likely grow at the sluggish pace of about 3%. A significant inventory of unsold housing in the Seoul area will constrain construction, as will large debts of private housing companies and the government’s Land & Housing Corporation. The corporation’s debts are an example of a more general problem of high and growing debt burdens of state-owned firms (Box 3.11.1).

Private consumption is projected to expand by 4.0%–4.5% in 2011, bolstered by growth in incomes. The labor market looks set to remain strong (up to 250,000 jobs will likely be generated, down a bit from last year owing to the expected moderation in growth of exports industries). Softness in export unit prices will weigh on terms of trade and gross domestic income. But gains in corporate profitability in 2010 will pave the way for more robust wage growth. A decline in housing prices that bottomed out in the second half of 2010 should support consumer confidence.

Inflation pressures surfaced toward end-2010 and are expected to intensify this year. Major price indicators are on the rise (Figure 3.11.7), with inflation breaching the central bank’s target band in January and February this year. Inflation in 2011 is forecast at 3.5%. It is expected to ease a little in 2012, when monetary policy will be tighter and global prices for oil and food are expected to decelerate.

Cost-push factors such as higher global oil and food prices have contributed to the rise in inflation, though aggregate demand is also putting upward pressure on prices. Additionally, as actual output has surpassed potential output since the first quarter of 2010 (Figure 3.11.8), it is likely that monetary policy will be tightened further to contain inflation.

The authorities are also using administrative measures to control prices of specific items, especially food. Further, in February 2011 the government advised that it would minimize increases in public utility charges.

The fiscal stimulus has been withdrawn as the economic recovery gathered pace. The overall fiscal deficit was reined in last year to 2.3%
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3.11.1 The rising debts of state-owned firms

The rapid increase in debt of state-owned firms may have damaging implications for future fiscal health. Public debt levels are low relative to Europe, Japan, and the United States, and public finances are generally in good shape.

This benign picture ignores, however, large and growing debts of 21 firms owned by the central government. Such debts are not part of the International Monetary Fund’s definition of public debts, but still represent contingent liabilities for the government.

As at end-2009, these firms’ total debt reached 235.1 trillion won ($201.4 billion), equivalent to 65.4% of public debt. Further, their debt grew by an average of 17.9% a year between 2004 and 2009, significantly faster than the growth in public debt (12.0%) (Box figure 1).

Critically, the ratio of short-term debt to total debt among state-owned firms is relatively low (Box figure 2) and the duration of borrowing is relatively long. They tend to have higher credit rating than private firms, facilitating their access to long-term credit, but few have “quick” assets that can be converted to cash at short notice. Their average ratio of current assets to short-term debt stood at 61.1% at end-2009, comparing unfavorably with the overall corporate average of 99.1%.

State-owned firms generally have low profit rates, although with wide variations. Of the six, the highways and petroleum firms have low debt and high profits. Profitability of the other four has declined in recent years due to excessive business expansion and restrictions on public utility tariff increases.

Without a severe shock, the risk of liquidity problems or bankruptcy among the 21 firms owned by the government appears limited in the short run. In the long run, however, they should strive to improve profitability so as to gradually reduce their debt burdens. While they are somewhat constrained from raising prices by public interest considerations, they should nevertheless operate along more commercial lines. (For political reasons the government is unlikely to be able to privatize them.)

It would therefore be helpful if the government allowed a gradual liberalization of public utility tariffs. Such firms should also become much more transparent about their financial health.
half will outperform the first, largely owing to the base effect. The outlook for 2012 is expected to be broadly similar to 2011’s.

The primary source of uncertainty involves monetary policy. The cost of keeping interest rates low, in terms of the impact on inflation, is likely to be significantly higher than in 2010. The GDP outcome will therefore partly depend on how the central bank resolves the trade-off between growth and inflation.

The large size and volatility of capital inflows remain a risk, although macroprudential measures adopted by the authorities are mitigating it. For example, tax exemptions for foreign investors that were introduced in May 2009 to promote bond market development are being rolled back, and the government has set a ceiling on foreign exchange–related derivatives to limit banks’ short-term foreign borrowing. External risks center on the trajectory of global commodity prices and recovery of industrialized countries.

The impact of the Japanese disaster will be limited and temporary. While exports that compete with Japan, such as autos and electronics, may benefit, disruptions to imports of capital goods will hurt manufacturers.

**Development challenges**

A key driver of private consumption growth in 2010 was the strong labor market. Growth of employment and wages is also expected to be a major positive factor in 2011, but paradoxically many job seekers cannot find work. A broad definition of work seekers includes the unemployed, those who work fewer than 36 hours a week and want to work more, and people who have never been employed or been out of the workforce for a long time but want to work. Their number shot up by 19.1% in 2009 to 1.8 million people, and rose by a further 5.4% in 2010, despite the economic recovery (Figure 3.11.10).

Several policy options can be considered. First, specialized skill training programs at small and medium-sized enterprises could be promoted for youths, especially high-school graduates, along with retraining for older individuals. This is important because youths and older people together accounted for around one fourth of work seekers in 2010, according to a study by Hyundai Research Institute.

Second, an expansion of public child care facilities would enable more women with children to stay in work (the share of females in work seekers rose from 39% in 2009 to 43% in 2010).

Third, given that unemployment became more prevalent among those, especially females, with junior college or higher education, education must become better aligned with the needs of employers. Employment information, too, should be made more widely available at universities and colleges.

Fourth, efforts should be made to facilitate the employment of those work seekers formerly employed by public job-creation programs.

Fifth, internship programs in both public and private sectors should be expanded as they give valuable work experience to those who have never worked before (individuals unemployed for less than a year accounted for the largest share of work seekers).