Republic of Korea

The export sector was surprisingly strong in 2011, but domestic demand wilted, resulting in economic growth below potential. Subpar growth is expected again this year, with the uncertain global outlook restraining trade and investment. Excessive household debt weighs heavily, prompting deleveraging but hampering efforts to lift the economy and reduce income disparities. Policy makers face the dual challenge of how best to shelter the economy from external risk and strengthen inclusive growth.

Economic performance

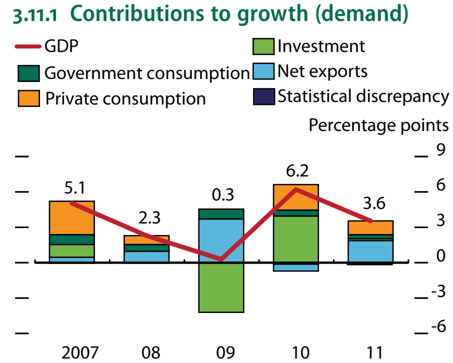
After surging by 6.2% in 2010, economic growth in the Republic of Korea slowed to 3.6% in 2011. As indicated by the economic performance prior to the 2008–2009 global financial crisis, a rate around 4% is closer to potential. A slowdown was expected—given the exceptionally high rate in 2010—but not to this degree. The underlying cause was sluggish domestic demand, particularly with respect to investment. Manufacturing output expanded by 7.1% and services by 2.6%, but construction contracted by 5.6%. The strength of manufacturing relates to exports as the mainstay of growth in 2011, a contrast with 2010, when high levels of consumption and investment spurred growth while the trade sector acted as a drag.

More precisely, net exports were strongly positive in 2011 (exports increased faster than imports) and accounted for over half GDP growth (Figure 3.11.1). Despite a much less rapid rise than in the previous year, private consumption added another third. Government consumption accounted for little, reflecting the completion of fiscal stimulus. Investment contributed even less as plant and equipment expenditures were relatively flat; facilities investment increased by less than 4%, down from 25% in 2010. Construction fell deeper into negative territory.

Growth momentum slowed during the year. Year on year, output was up 4.2% in the first quarter but then fell to the 3.5% range in the subsequent 3 quarters. Softening of growth was more evident quarter on quarter (Figure 3.11.2): reflecting the growing weakness of the economy, all the main components of GDP expenditure contracted in the fourth. This drop-off was especially pronounced for plant and equipment investment, but also extended to exports. The decelerating growth momentum closely paralleled the deteriorating global outlook.

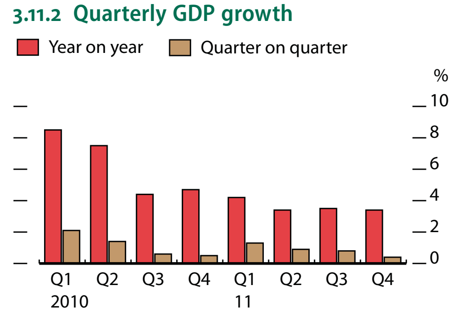
Merchandise exports increased in nominal terms by a subdued but still-healthy 20.0% in 2011 (versus 28.8% in 2010), underscoring exports' resilience. Export growth year on year, however, slowed steadily from 26.5% in the first quarter to 12.1% in the fourth (Figure 3.11.3). A flurry of ship orders and March's earthquake in Japan initially buttressed exports, but as the year progressed, softening demand—notably from the

3.11.1 Contributions to growth (demand)



Sources: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 1 February 2012); ADB estimates.

3.11.2 Quarterly GDP growth



Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 1 February 2012).

This chapter was written by Donghyun Park of the Economics and Research Department, ADB, Manila.

European Union—markedly dented the momentum of export-led growth. Robust exports to developing Asia only partly offset weakening demand from advanced economies. In turn, import growth fell steadily over the year, indicative of softening domestic demand. Merchandise imports rose by 23.8%, down from 31.5% in 2010. The pattern for services trade was broadly similar. The current account surplus is estimated to be the equivalent of 2.5% of GDP, slightly lower than in 2010. The won exchange rate against the dollar remained essentially unchanged at 1,100 (it was 1,150 in 2010).

Private consumption climbed by only 2.2% in 2011, half the year-earlier rate. As was the case with the export sector, it also weakened progressively during the year, starting with growth of almost 3% but falling to just over 1% by the fourth quarter (Figure 3.11.4). Consumer confidence fell in tandem, eroded by inflation and declining real household purchasing power. Further, gross domestic income increased by only 1%, as higher oil prices and a deterioration of the terms of trade cut into disposable income. The one positive note was a large pickup in employment of some 400,000, much higher than the usual 250,000.

The sharp investment slowdown is reflected in the industrial production index and the ratio of producer's shipments to inventory (Figure 3.11.5). Investment in export-oriented industries such as automobiles and semiconductors fell in parallel with the global outlook. The slowdown also partly reflects normalization from the exceptionally rapid investment growth of 2010. Construction investment contracted, reflecting the weak housing market and subdued public works activity.

Inflation, as measured by the consumer price index, rose to 4.0%, the upper limit of the Bank of Korea's inflation target band. Supply-side factors included domestic food prices as well as oil and other commodity prices. The spike in domestic food prices was caused by bad weather. While supply-side factors were the immediate catalyst of higher inflation in 2011, aggregate demand pressures also played a role. The central bank raised the policy interest rate during the first half of the year, then held monetary policy steady in light of the global outlook (Figure 3.11.6).

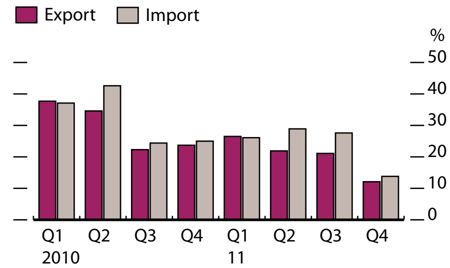
The government continued to consolidate its financial position, which had been sharply expansionary in response to the global financial crisis. The fiscal deficit narrowed progressively, to 0.7% of GDP from 4.8% in 2009 and 1.5% in 2010. Government expenditure rose to 21.2% of GDP and revenue even more significantly to 20.5%; the ratio of public debt to GDP fell marginally to 35%.

In summary, the country's overall economic performance in 2011 was worse than expected, largely due to the deteriorating global outlook as the year unfolded. Even though export growth slowed progressively during the year, it remained the main driver. Private consumption was supportive while investment lost steam.

Economic prospects

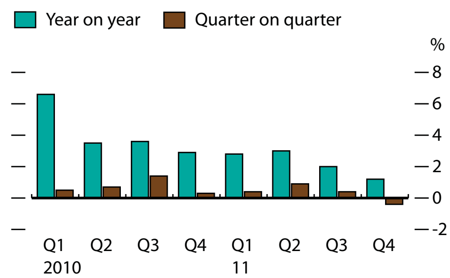
Growth for 2012 is forecast at 3.4% (below potential), rising moderately in 2013 to 4.0%. These rates are based on the expectation that the Republic of Korea's main export markets, including the European Union, the United States (US), and Japan, will experience slow growth at best. Thus the

3.11.3 Merchandise export and import growth



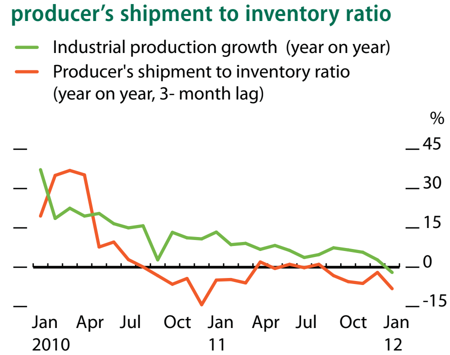
Source: CEIC Data Company (accessed 21 February 2012).

3.11.4 Private consumption growth



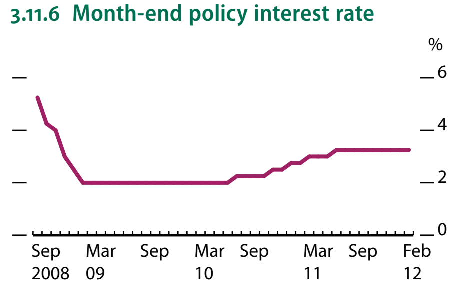
Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 1 February 2012).

3.11.5 Monthly industrial production and producer's shipment to inventory ratio



Sources: CEIC Data Company (accessed 6 March 2012); ADB estimates.

3.11.6 Month-end policy interest rate



Source: CEIC Data Company (accessed 8 March 2012).

pessimistic global outlook that so hampered the country's performance in the second half of 2011 will set the tone for the forecast period.

Exports in nominal terms are expected to increase by about 8% in 2012, or less than half last year's rate. Export unit prices are expected to remain flat, in contrast to significant gains in 2011. The fragile state of economic recovery in advanced countries is constraining demand for key exports from the Republic of Korea, such as automobiles, electronics, and other consumer durables. Demand for key ICT parts, such as memory chips used in personal computers, has also been affected.

More positively, exports of general machinery and other goods to the People's Republic of China and other emerging markets in Asia are expected to remain strong. Petrochemical exports will also be robust, including those to Japan. Overall export growth is projected to strengthen gradually during 2012 and into 2013, in line with a gradually improving global outlook. Imports will likely climb faster than exports, and the current account surplus to decline to around 2.0% of GDP. The US dollar exchange rate is unlikely to change much either way.

Investment is forecast to increase by little more than 2% in 2012. Subdued investment, especially in the export sector, has mirrored the worsening external environment. Corporate investment surveys indicate that major Korean firms plan to reduce investment relative to their levels in 2011 by 5–10%. Beyond weak business sentiment, an impediment to stronger investment is the decline in corporate profitability, notably among ICT firms. Another negative element for equipment investment is the recent fall in capacity utilization (Figure 3.11.7). Construction investment, including housing, which contracted in both 2010 and 2011, is expected to increase, but only moderately. Overall investment is expected to strengthen in the second half of 2012 as the global outlook picks up.

Private consumption is projected to increase by about 3% in 2012, or somewhat more strongly than in 2011. Various factors constrain its growth, though. Consumer confidence is weak (Figure 3.11.8) and is unlikely to strengthen until the global outlook improves convincingly. Purchases of consumer durables, especially automobiles, may be constrained by the prospective free trade agreement with the US, which is expected to lower prices. Further, sluggish exports will limit wage growth and ultimately private consumption. Real wage growth has lagged GDP growth since the mid-2000s and this trend is likely to continue. Excessive household debt also constrains increased private consumption, especially among low-income groups. On the positive side, inflation pressures are expected to ease and to help raise household purchasing power.

Inflation is forecast to decline to 3.0%, a full percentage lower than in 2011. It is anticipated that the ratcheting down of global growth predictions for 2012 and 2013 will be tracked by moderating commodity prices and help ease core inflation. However, international oil and food prices are volatile; they were high in the first part of 2011 then eased, but oil prices have again risen sharply. Supply shocks—such as a spike in oil prices—could prove highly disruptive. A firmer basis for optimism on inflation is the abatement of domestic demand pressures and the projected disappearance of the small inflationary gap that emerged in 2011 (Figure 3.11.9).

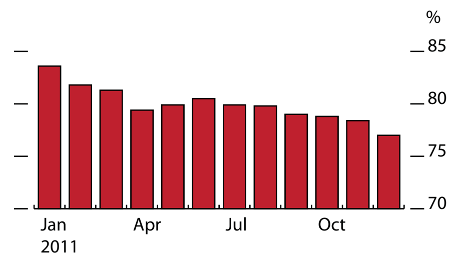
Employment is forecast to increase by 250,000—healthy but far short of the exceptional gain in 2011. The elasticity of employment growth

3.11.1 Selected economic indicators (%)

	2012	2013
GDP growth	3.4	4.0
Inflation	3.0	3.0
Current account balance (share of GDP)	2.0	2.0

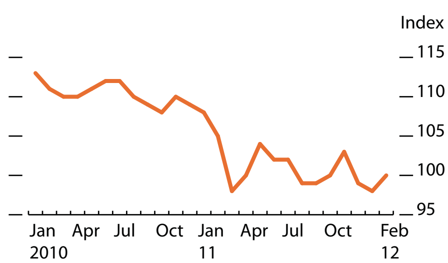
Source: ADB estimates.

3.11.7 Capacity utilization ratio



Source: CEIC Data Company (accessed 6 March 2012).

3.11.8 Consumer confidence



Source: Bank of Korea. Economic Statistics System. http://ecos.bok.or.kr (accessed 6 March 2012).

relative to GDP growth in recent years reflects the large expansion of labor supply. This, in turn, stems from the reentry of retired 50-plus baby boomers into the workforce, usually self-employed, to cope with insufficient retirement income. "Silver workers"—those 60 and over—now constitute around 12% of the workforce. For those 65 and older, the employment rate is more than double the OECD average. Except for professionals, these workers are typically unskilled, on low wages and with little job security. Self-employment in small, scarcely profitable retail outlets is common. Strong employment growth therefore masks questions about the quality of employment.

The current basic monetary and fiscal policy framework is likely to continue—that is, to lower inflation while supporting growth. The policy interest rate is expected to remain largely unchanged. Although the adverse global environment may call for stimulus—including yet lower interest rates—the current policy rate of 3.25% is already accommodative. High and growing household debt further weakens the case for monetary loosening (Figure 3.11.10). The Bank of Korea will closely monitor developments, tightening monetary policy if inflationary pressures revive but loosening it if the economic outlook deteriorates further.

The fiscal position is fundamentally sound, as indicated by the public debt-to-GDP ratio of 35%, which is far lower than the OECD average. The relatively favorable fiscal conditions support continued consolidation within a medium-term fiscal framework. Public expenditure requirements associated with the country's aging population, among other pressures, call for a gradual buildup in the fiscal position. The government is targeting fiscal balance by 2014, if not sooner.

Summarizing the above considerations, GDP growth is likely to remain slightly below potential in the short term (Figure 3.11.11). Although domestic demand will help cushion some of the loss of momentum since the exceptional growth in 2010, the recovery will be gradual—tracking the global outlook.

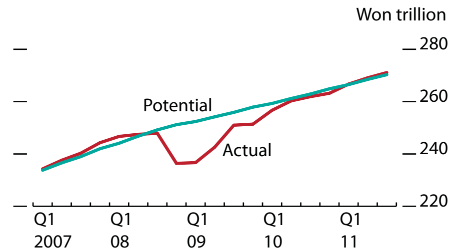
The main short-term downside risk for the economy stems from the eurozone's sovereign debt issue: the speed and effectiveness of its resolution bear heavily on the global outlook and hence prospects for Korean exporters. If the situation deteriorates into another global financial crisis, exports and GDP growth would be hard hit, as in 2008–2009. Alternatively, if the eurozone crisis is resolved faster and better than expected, growth could surprise on the upside.

Another source of external uncertainty is the potential impact on global oil prices of Middle Eastern geopolitical tensions. Concern over the change of political leadership in the Democratic People's Republic of Korea has abated. A domestic risk is the high and growing level of household debt.

Policy challenge—household debt

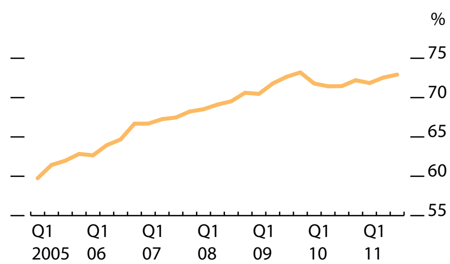
Household debt has continued to climb rapidly, despite regulatory efforts. However, the current surge in household debt appears to be driven by financing of consumption rather than purchases of homes, and the ratio of nonhousing to housing loans is rising (Figure 3.11.12). Further, household debt rose by 9% in 2011 whereas financial assets and real

3.11.9 Potential versus actual GDP, Q1 2007–Q3 2011



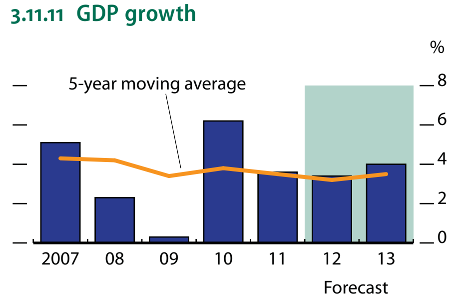
Source: LG Economic Research Institute.

3.11.10 Household debt-to-GDP ratio



Sources: Bank of Korea. Economic Statistics System. http://ecos.bok.or.kr; ADB estimates.

3.11.11 GDP growth



Sources: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 1 February 2012); ADB estimates.

estate owned by households went up by only 7.1%. This supports the view that households, in response to shrinking real disposable incomes, are borrowing more to finance consumption. It is expected that increases in household debt will slow in 2012, as the financial authorities are likely to clamp down on household borrowing to protect the soundness of the financial sector. The weak housing market will weigh on household loans and should act to help constrain the growth of household debt.

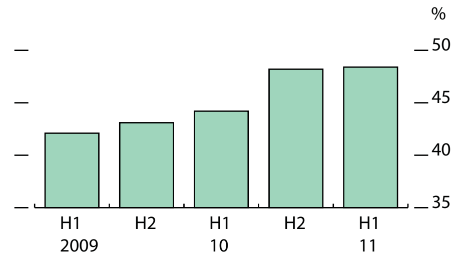
High and growing household debt may be a domestic risk for the economy, but the probability of it causing a macro financial crisis is quite small. The ratio of nonperforming household loans stood at 0.8% at end-2011. The banking sector's improved profitability and stronger capacity to absorb losses further reduces the likelihood of a financial crisis. Stringent loan-to-value regulations minimize the risk of a vicious cycle of falling housing prices and rising numbers of nonperforming loans. Household debt repayment pressures still affect macroeconomic performance though, because they crimp disposable income, private consumption, and aggregate demand.

Household debt also seriously affects certain groups of households and components of the financial sector. Low-income households may face financial difficulties for two reasons. First, slow economic and hence income growth limits their repayment capacity. Second, repayment pressures are likely to intensify owing to government efforts to rein in household debt. Financial institutions will become more cautious in rolling over loans and demand quicker repayment of the principal. For households in the bottom 20% by income, the ratio of debt to disposable income rose sharply in 2011 (Figure 3.11.13). Low-income households earning less than 20 million won annually accounted for about 40% of total loans, and these loans are more at risk of becoming nonperforming.

A related area of concern is the so-called secondary financial sector. This sector consists of financial institutions that deal extensively with borrowers with poor credit ratings and that have only limited capacity to absorb losses. The ratio of subprime loans and nonperforming loans has already risen sharply for these institutions. If the risk premium rises in response, borrowers' repayment ability will decline, setting in train a potentially intensifying cycle of nonrepayment by borrowers and worsening balance sheets in the secondary financial sector.

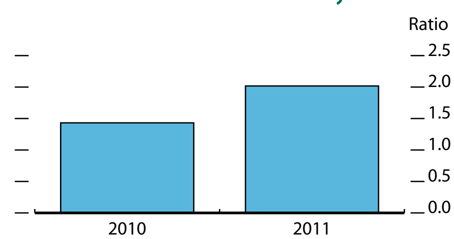
In 2011, authorities introduced several measures to address household debt. These included reinstatement of debt-to-income limits for mortgage loans and various measures to ensure low-income households' access to loans through the primary financial sector. While these measures are encouraging, authorities will need to closely monitor the growth of household debt, especially loans from the secondary financial sector to low-income households, and to take further cautionary measures.

3.11.12 Share of nonhousing loans



Source: LG Economic Research Institute.

3.11.13 Debt to disposable income, households in the bottom 20% by income



Source: LG Economic Research Institute.