Republic of Korea

The adverse global outlook took its toll on exports, investment plummeted, and growth disappointed at 2% in 2012. Meanwhile, inflation abated, and the current account surplus widened. Modest improvement in external conditions will sow the seeds of recovery, and growth will pick up gently to 2.8% in 2013, with inflation remaining low and the current account surplus narrowing. Fiscal and monetary policy will broadly accommodate growth. Preventing and mitigating old-age poverty poses a high-priority policy challenge.

Economic performance

Last year was greatly challenging, in particular because weaker demand from the advanced economies and the People’s Republic of China (PRC), the Republic of Korea’s biggest market, dealt a double blow that knocked the wind out of exports and growth momentum. The adverse external outlook had knock-on effects on domestic demand, especially plant and equipment investment. Mildly accommodative monetary and fiscal policy provided some relief, but growth slowed significantly from 3.7% in 2011 to 2.0% in 2012. In parallel with global outlook trends, in particular the evolution of the euro area crisis, growth momentum weakened from the first quarter to the second and third quarters before picking up somewhat in the fourth quarter (Figure 3.11.1).

Feeble domestic demand provided little relief from the fragile external environment. Plant and equipment investment, heavily dependent on exports and sensitive to the global business cycle, contracted by 1.9% after expanding by 3.6% in 2011. Construction also contracted because of the stagnant housing market and feeble private sector demand overall. Private consumption growth moderated from 2.4% in 2011 to 1.7% in 2012, as large household debt and the stagnant housing market combined to outweigh the influence of a healthy employment gain of 440,000, which kept the unemployment rate at 3.2%.

Except for government consumption, all components of aggregate demand made smaller contributions to growth in 2012 than in 2011 (Figure 3.11.2). The contribution of net exports fell by half from 1.8 percentage points in 2011, and that of investment plummeted into negative territory from 0.4 percentage points in 2011. In short, the uncertain global outlook precipitated slower exports and an outright contraction of investment. Disappointing performance in 2012 marks a further deceleration from the 6.3% growth of 2010 and is fueling broader concerns about growth prospects over the medium and long term.

The persistent softness of demand from advanced economies, combined with the palpable slowdown of the PRC economy, made 2012 especially difficult for exporters. Year on year, merchandise exports grew...
by a mere 0.1% in 2012, a sharp decline from the 19.6% of 2011. Export growth was muted throughout the year (Figure 3.11.3). The one bright spot in an otherwise grim export environment was the robust market in the Association of Southeast Asian Nations (Figure 3.11.4).

Mirroring the fragility of domestic demand, imports of goods plummeted by 1.1% in 2012 from the 23.4% growth in 2011, leaving a yawning trade surplus. At the same time a sizeable surplus in construction services combined with smaller deficits in tourism and business services to reverse the chronic services trade deficit to a record surplus. These developments added up to a record current account surplus of $43.1 billion, or 3.8% of GDP, even though the won strengthened somewhat, rising from 1,146 to the dollar in January to 1,077 in December.

Inflation as measured by the consumer price index averaged 2.2%, down sharply from the 4.0% of 2011 but remaining within the central bank’s inflation target band of 3.0% ±1 percentage point. Inflation decelerated during the course of the year as aggregate demand progressively softened (Figure 3.11.5). The lack of inflationary pressures and concerns about growth prodded the central bank to gradually loosen monetary policy during 2012, cutting its benchmark policy rate from 3.25% to 3.00% in July and further to 2.75% in October.

Fiscal policy was also mildly expansionary but well short of a full-fledged stimulus. The fiscal deficit was 2.9% of GDP, somewhat similar to the previous 2 years, and the ratio of public debt to GDP edged up slightly to 34.8% from 34.0%. Reflecting positive fiscal developments, all three major credit rating agencies—Moody’s, Fitch, and Standard and Poor’s—upgraded the Republic of Korea’s sovereign credit rating in 2012.

**Economic prospects**

Looking forward, 2013 will see the beginning of a recovery, which will gain traction as the global recovery finds its footing in 2014. GDP growth is likely to improve modestly to 2.8% in 2013 from 2.0% in 2012. A full-fledged recovery will have to wait until 2014, when GDP growth will strengthen to 3.7% (Figure 3.11.6). While domestic demand will contribute to growth in 2013, it will be nowhere near robust enough to qualitatively change the gradual and limited nature of recovery in 2013. Uncertainties in the global outlook regarding the advanced economies will continue to cast a dark cloud over global trade during the first half. But those uncertainties are expected to ease during the second half. The Republic of Korea’s performance will mirror the expected trajectory of the world economy, with growth in the second half of the year slightly outperforming expansion in the first half.

Merchandise export growth is set to rise modestly from 0.1% in 2012 to above 7% in 2013, as factors contributing to faster growth are likely to outweigh those depressing it. Stronger export growth since the fourth quarter of 2012 buttresses such cautious optimism. Exports to the PRC stand to benefit from that country’s widely expected stronger growth. On the other hand, limited fiscal stimulus in developing countries and fiscal austerity in the advanced economies will firmly cap aggregate export demand (Figure 3.11.7). Export growth will thus be muted overall—unlike the V-shaped rebound after the global financial crisis—but will
mark an exit from the export distress of 2012. Meanwhile, imports are likely to rise in 2013 and 2014, reflecting strengthening domestic demand, and shrink the current account surplus to 3.0% of GDP in 2013 and 2.5% of GDP in 2014.

In line with the trajectory of the global outlook, investment will contract in the first half but grow at a healthy pace of 3.0% or better in the second half, on the back of growing outlays in export-oriented industries and sectors. The effect of exports on equipment investment, traditionally high for this export-dependent country, is likely to be acute. Uncertainty in the post-crisis period encouraged firms to base their investment decisions more on visible short-term export trends than on highly uncertain long-term prospects. Looking forward, while business confidence remains fragile, low interest rates, the strong won, and tightening capacity utilization in recent months will provide impetus to investment (Figure 3.11.8). As a result, plant and equipment investment is likely to bounce back gradually in tandem with export recovery. Construction investment, which has contracted for 3 consecutive years, is set to grow by 2.0%. The modest turnaround will center on public works and nonresidential buildings, while the sluggish housing market will continue to stymie residential construction. Private consumption growth is projected to strengthen from 1.7% in 2012 to close to 3.0% in 2013, in light of the expected pickup in exports, relative price stability, healthy employment gains, and moderating uncertainties.

In line with the modest pickup of growth, consumer price index inflation will rise slightly from 2.2% in 2012 to 2.5% in 2013 and 2.8% in 2014. This outcome reflects the evolution of several factors affecting prices. Since the Republic of Korea’s potential GDP growth rate is estimated to be between 3.5% and 4.0%, a deflationary gap, which emerged during the second quarter of 2012, will persist well into 2013 (Figure 3.11.9). Feeble domestic demand, fierce competition among recently proliferating self-employed service providers, the projected moderation of global oil prices, and the appreciation of the won will all alleviate inflationary pressures. On the other hand, an exceptionally cold winter may trigger higher food prices, and long-frozen fees for some public services are due to be raised this year. In addition, incomes will grow as employment rises by an estimated 300,000 jobs. This employment expansion, while less than in 2012, continues a long-term trend of healthy employment growth.

Monetary policy aims to lower inflation to a rate like those experienced in advance countries. To this end, the central bank lowered and tightened the inflation target band from 3.0% ±1 percentage point to 2.5%–3.5%. However, this policy is likely to be tempered by a desire to support growth, so the central bank is likely to cut interest rates in the first half of 2013.

The basic stance of fiscal policy in 2013 and 2014 will be to support economic growth in the face of feeble aggregate demand. To this end, the budget will likely record a deficit of 0.3% of GDP in 2013. This is less than the 2.9% of 2012 and shrinks the ratio of public debt to GDP from 34.8% to 34.3%, but the government will nevertheless adopt a concerted countercyclical fiscal approach in the short run by frontloading 60% of its budget during the first half of the year, gearing the composition
of expenditures toward maximizing support for growth. In particular, budget items targeted for significant expansion are social overhead capital investment, assistance to small and medium-sized enterprises, and job creation programs.

This baseline economic outlook is subject to a number of risks. GDP forecasts are fraught with uncertainty arising from persistent uncertainty in the global outlook. The upside and downside risks are finely balanced, however, with the short-term performance of the US and euro area economies constituting the main sources of both upside and downside risk for the Republic of Korea.

Protectionism, including competitive depreciation stemming from quantitative easing, is another potential risk. In this context, the sharp depreciation of the yen is of special concern because Japan and the Republic of Korea compete in many export industries (Figure 3.11.10). However, this concern is tempered by the likely positive impact of the weaker yen on the economy’s competitiveness, as the Republic of Korea imports large amounts of capital and intermediate goods from Japan.

There is also political risk arising from the unpredictability of the Democratic People’s Republic of Korea, which can shake the financial markets and have spillover effects on the economy in the south.

On the domestic front, the high and growing household debt—the perennial domestic risk—continues to weigh on private consumption even as it becomes less of a systemic financial and economic risk. There has been no noticeable uptick in consumer confidence. The average propensity to consume—the ratio of consumption to disposable income—fell from 78% before the crisis to 76% in 2012. For low-income groups, anxieties about possible unemployment in a weak economy seem to constrain consumption. For higher-income groups, their deleveraging to reduce household debt burdens, compounded by stagnant housing prices, limit the propensity to consume (Figure 3.11.11). These risks suggest that private consumption may not grow as assumed under the baseline outlook.

More broadly, the economy’s visibly slower and more volatile growth during the past 5 years has raised concerns about growth prospects over the medium and long term.

On the positive side, there are no major, high-probability systematic risks to financial stability. Even worst-case estimates of the impact of large household debt on banks’ balance sheets are deemed manageable. The risk from the mounting bad loans of savings banks—second-tier financial institutions—has also been addressed through extensive restructuring. Moreover, prudent fiscal policy has created sufficient fiscal space should there be a crisis that demands a large stimulus. Indeed, rating agencies’ sovereign credit rating upgrades reflect a market vote of confidence in the government’s ability to tackle a crisis without sacrificing fiscal sustainability.

**Policy challenge—mitigating old-age poverty**

The Republic of Korea needs to find ways to deliver affordable, adequate, and sustainable income support for its elderly population, which is one of the fastest growing in the world (Figure 3.11.12). The country introduced...
a public national pension system only in 1988, and, among members of the Organisation for Economic Co-operation and Development, it ranks second, after Mexico, for its meager share of GDP devoted to social spending. At the same time, traditional reliance on families is being eroded by extensive socioeconomic change. Most worryingly, rates of poverty and extreme poverty among the elderly rose from 2006 to 2011. The risk of widespread old-age poverty has thus emerged as a major social and economic concern in recent years (Table 3.11.2). This issue was arguably the hottest subject of debate during the December 2012 presidential election, in which all candidates promised to devote more resources to mitigating old-age poverty.

The Basic Old-Age Pension (BOAP) is a noncontributory social scheme introduced in 2008 that uses general revenues to pay pensions to the elderly poor. Its central objective was to provide a safety net for many elderly who were at risk of falling into poverty because they were not covered by either the national pension system or the anti-poverty social security system unrelated to age. This coverage gap, while narrowing, is expected to remain substantial for years to come.

As designed, the BOAP suffers some serious flaws that ill-suit it to mitigating old-age poverty. First, as 30%–40% of the elderly live with their children, a lot of the assistance ends up in the hands of relatively well-to-do elderly who live with well-to-do children. According to KDI, an autonomous development institute set up by the Republic of Korea, 54.2% of the households in the wealthiest 10% of households with elderly members received BOAP benefits, suggesting that a substantial share of benefits flow to the better off. Second, the BOAP targets the poorest 70% of the elderly, which includes many higher-income elderly who do not actually need support. Third, many elderly poor, especially those not living with their children, fail to apply for the BOAP for lack of information. Fourth, owing to its noncontributory nature, the BOAP can blunt incentives to join the national pension system because it requires a contribution, thereby raising budgetary costs.

In February 2013, the incoming administration announced a plan to extend BOAP coverage to the entire elderly population and double the benefits paid out to the poorest 70%. Among other equity concerns, the proposed plan favors non-contributors over contributors, thereby making it very controversial, throwing its passage by the legislature into doubt, and undermining its efficacy in mitigating old-age poverty.

To reduce inequities and budgetary costs and make the BOAP more effective, benefit amounts and eligibility should be carefully designed to minimize disincentives to joining the national pension system. In particular, BOAP eligibility should depend on a well-defined measure of poverty, rather than on an arbitrary percentage of poor elderly. For the elderly living with their children, eligibility should take into account children’s income. The primary, longer-term objective of pension reform must be to extend coverage under the main national pension system to the entire population.

### Table 3.11.2 Poverty rates among the elderly, 2006 and 2011 (%)

<table>
<thead>
<tr>
<th>Age</th>
<th>2006</th>
<th>2011</th>
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<tbody>
<tr>
<td>65–69</td>
<td>38.0 (9.4)</td>
<td>40.0 (15.2)</td>
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<tr>
<td>70–74</td>
<td>45.2 (13.0)</td>
<td>52.3 (21.4)</td>
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<tr>
<td>75–79</td>
<td>53.7 (22.6)</td>
<td>57.8 (27.6)</td>
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<tr>
<td>80+</td>
<td>45.4 (18.3)</td>
<td>51.4 (28.8)</td>
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<tr>
<td>60+</td>
<td>43.8 (14.0)</td>
<td>48.8 (21.4)</td>
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Note: Numbers inside parentheses indicate extreme poverty rate. Poverty rate refers to the share of the population with income below 50% of the median income. Extreme poverty rate refers to the share of the population with income below 25% of the median income.

Source: Korea Development Institute.