Republic of Korea

Growth picked up moderately in 2013 as inflation slowed and the current account surplus expanded. Growth will accelerate this year and the next, unaffected by moderation in the People’s Republic of China, with inflation higher but still low and with shrinking current account surpluses. Inducing more women to join the workforce remains a high-priority policy challenge.

**Economic performance**

The economy accelerated gently from 2.0% in 2012 to an estimated 2.8% in 2013, somewhat less than expected at the beginning of the year because exports remained soft. Budding recovery in the advanced economies, especially the US, did not translate into an increase in exports. Nevertheless, exports made a tangible contribution to growth, reflecting the improving global outlook. Mirroring the world economy, GDP growth accelerated from below 2.0% in the first half to above 3.5% in the second half, exhibiting a clear strengthening trend since the fourth quarter of 2012 (Figure 3.11.1).

The main driver of growth in 2013 was healthy domestic demand, spurred by a solid employment gain of 386,000 jobs and accommodative government policies. Private consumption was the most dynamic component of demand, expanding by 1.7% on a consistently rising trend throughout the year (Figure 3.11.2) and adding 1.0 percentage point to GDP growth. Government consumption also remained robust, contributing another 0.5 percentage points (Figure 3.11.3). Investment registered a large turnaround, adding 0.7 percentage points to growth after subtracting 0.5 percentage points in 2012. Net exports made a similar contribution of 0.6 percentage points.

The pickup in investment was spurred by a big improvement in construction, which more than offset falling investment in plant and equipment. Construction investment grew by 6.9% after 3 straight years of contraction and remained buoyant throughout the year. An unexpectedly weak export performance took its toll on plant and equipment investment, which fell by 1.5% following a 1.9% contraction in 2012. The high-tech manufacturing sector, geared toward exports to the advanced economies, was especially hard hit, and investment in machinery continued to shrink.

On the supply side, robust construction did not translate into faster growth of value added in the service sector, which expanded by 2.4% in 2013, slightly down from 2.5% in 2012. Manufacturing growth accelerated to 3.0% from 2.2%, while exceptionally favorable weather fostered robust 5.6% growth of agriculture in 2013, on the heels of a 0.6% slide in 2012.

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The inflationary impact of rising domestic demand was more than compensated by the improved agricultural outcome and soft global commodity prices, which brought lower inflation. The consumer price index averaged 1.3%, down from 2.2% of 2012, its lowest level since 2000 and well below the Bank of Korea’s inflation target band of 3.0% ± 0.5% (Figure 3.11.4).

Monetary and fiscal policies were expansionary during 2013. Low inflation did not raise the specter of deflation but enabled the Bank of Korea to cut its benchmark policy rate from 2.75% to 2.50% in May, facilitating an expansion of domestic liquidity. Fiscal policy provided by far the bigger impetus to growth. Including the $16 billion supplementary budget, the fiscal deficit rose to 1.8% of GDP from 1.4% in 2012, and the ratio of sovereign debt to GDP climbed to 36.2% from 34.8%.

Trends in external trade and services balances brought the current account surplus to a record $71 billion, or 5.8% of GDP, up from $48 billion in 2012. Merchandise exports grew by 3.0%, up from 0.4% in 2012, while merchandise imports shrank by 0.8%, following a 1.1% contraction in 2012 (Figure 3.11.5). Lower global commodity prices underlay the softness of imports, while export growth strengthened in tandem with the global outlook. Notably, exports to the People’s Republic of China remained resilient in the face of that country’s growth moderation. The services trade surplus soared from $270 million in 2012 to $6 billion as business service imports fell sharply. The surplus in the overall balance boosted official foreign exchange reserves to $335.6 billion at the end of 2013.

The Republic of Korea won averaged 1,094 to the dollar in 2013, somewhat stronger than the 1,126 of 2012, and the real exchange rate also strengthened during the second half of the year (Figure 3.11.6). These developments did not appear to have tamped down export demand or raised import demand.

The economic outcome in 2013 marks a moderate improvement from the disappointing performance of 2012. Growth still underperformed market expectations because exports were lackluster, but the stronger second half bodes well for 2014.

Economic prospects
GDP growth is forecast to accelerate to 3.7% in 2014, fueled by strong exports and private consumption (Figure 3.11.7). The improvement of the global outlook, which became evident in the second half of 2013, is expected to strengthen in 2014, benefiting this highly export-oriented economy. The expected robust recovery of consumption in the US and other advanced economies will especially boost durable and information technology exports, while exports to the People’s Republic of China and other developing countries will continue to grow at a healthy pace. Merchandise export growth is thus forecast to rise above 6.0% in 2014, as the trend in the second half of 2013 is expected to persist.

Private consumption will supplement exports as a driver of growth in 2014 and 2015, as a higher export volume combines with improving terms of trade to boost household disposable income. Consumer confidence is on the mend, as uncertainties associated with restrictions on chaebols...
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(large conglomerates) and the tapering of US quantitative easing are expected to recede (Figure 3.11.8).

Growth in private consumption is projected to strengthen to 3.0% in 2014 as it closely tracks gross national disposable income, which is expected to grow at a solid pace. The job market will be another bright spot, with an employment gain of over 400,000 jobs expected. The combination of robust employment, the reversal of the recent downward slide in asset prices, and a stronger currency also augurs well for household spending. These factors will likely dampen the impact of any increase in interest rates, which could restrict consumption by raising the debt service burden.

After 2 years of contraction, investment in plant and equipment is expected to increase by over 5% on the back of rising exports, substantially outpacing projected GDP growth. The rebound will not extend, however, to sectors plagued by excess capacity, such as steel and petrochemicals. Construction investment growth will remain positive but slow to below 2%, well short of the 2013 outcome, which was a one-off driven by temporary public works, rather than the beginning of a trend. Investment in residential construction will remain subdued despite some pickup in private sector activity (Figure 3.11.9).

Imports will outpace exports as they grow by more than 8% on the back of stronger domestic demand. As a result, the current account surplus will shrink to $42 billion, or 4.1% of GDP. In short, 2014 will mark the consolidation and firming of recovery in the Republic of Korea, which will persist into 2015.

Consumer price index inflation will pick up to 2.1% in 2014, as growth momentum firms and the rise in agricultural output diminishes. Stable global commodity prices and the strong won will persist, holding down import prices, but demand-side pressures will gain strength. In light of the energy sector’s growing debt, electricity charges may escalate significantly.

Despite the improving outlook, fiscal and monetary policy will remain mildly expansionary in 2014. The relatively tame recovery rules out a quick and decisive change of policy direction. The Bank of Korea is thus expected to keep its policy interest rate unchanged in the absence of any big shock. The projected fiscal deficit for 2014 is 1.8%, identical to that of 2013, such that the ratio of public debt to GDP will likely rise to 36.5% from 36.2%. The Republic of Korea has run fiscal deficits every year since 2008, and the public debt ratio has grown consistently.

The brightening global outlook will continue to exert a positive effect in 2015. Growth is forecast to pick up marginally to 3.8% from 3.7% in 2014. Consumer inflation will likely rise to 2.5% from 2.1%, and the current account surplus is projected to continue shrinking marginally, from 4.1% to 4.0%.

Overall, risk and uncertainty in the economy are likely to recede in 2014, as the global recovery gains traction and global financial markets become accustomed to the tapering of US quantitative easing. Upside risks to this assessment outweigh downside risks, so growth
may pleasantly surprise. The Republic of Korea’s financial stability is evident from its low and declining credit default spread (Figure 3.11.10) and will be shielded by its strong fundamentals such as a solid current account surplus and formidable foreign exchange reserves. Nevertheless, US tapering can exert a sizable indirect impact if it rekindles significant financial stress in the euro area and emerging markets, which collectively form a substantial export market for the Republic of Korea. Domestically, the growth of household debt is slowing, but the structure of mortgages, which account for half of household debt, remains a source of concern. A large part of mortgage debt is short term, variable interest, and single repayment, rendering it vulnerable to interest rate shocks and housing price decline.

The single biggest risk affecting the generally benign economic outlook for 2014 is the steady appreciation of the won relative to the yen (Figure 3.11.11). This will adversely affect export competitiveness vis-à-vis Japan, as exporters in the two countries compete in many markets. According to 2013 estimates by Hyundai Research Institute, yen depreciation to 100 per US dollar would reduce the Republic of Korea’s exports by 2.6% and shave up to 0.2% off its GDP growth; further yen depreciation to 120 per US dollar would almost triple this export reduction to 7.3%. Won appreciation against the yen would also reduce net tourism and corporate market value as external competitiveness suffers.

While growth momentum is expected to firm up in 2014 and 2015, widespread concerns about the visible loss of dynamism since the global crisis are likely to linger. To some extent, the growth slowdown reflects the maturing of the Republic of Korea as a high-income economy. Nevertheless, its policy makers are exploring policy options to lift long-term growth. On 25 February 2014, the government announced a three-pronged growth strategy: fostering the creative economy, reforming state-owned enterprises, and strengthening domestic demand. Another emphasis is deregulation, especially in the service sector, toward revitalizing private investment. Yet another option is to increase the workforce participation of women, which remains below the average for member economies of the Organisation for Economic Co-operation and Development (OECD) despite recent gains (see below). However, the impact of these policies is unlikely to be felt during the forecast period.

Policy challenge—lifting the employment of women

The Republic of Korea may soon face labor shortages as its population rapidly ages. One obvious solution is to encourage more women to work. The country’s female workforce participation rate stood at 55.2% in 2012, the lowest figure among the 34 OECD member countries, which averaged 62.3%. The gap is most pronounced among university graduates. By contrast, the Republic of Korea’s high school graduation rate is the highest in the OECD. As 74.3% of Korean female high school graduates continue to university—a rate even higher than the 68.6% for males—the underutilization of female labor masks the underutilization of a highly educated portion of the potential workforce.

The fundamental reason behind the underemployment of Korean women is that many of them drop out of the workforce in their 30s.
Pregnancy, childbirth, and child-raising are the immediate causes for leaving the workplace. Only 56.0% of all women in their 30s are economically active. The female employment rate fails to recover strongly in later years, peaking at 64.6% in the 40s. By contrast, the male employment rate surges to 90.3% in the 30s and rises further to 91.7% in the 40s, creating a large gender gap.

According to a 2013 Hyundai Research Institute report, the experiences of Germany, the Netherlands, and the United Kingdom can provide good benchmarks for the Republic of Korea. Those countries have higher female workforce participation, which in the case of female university graduates exceeds 80.0%, far above the Republic of Korea’s 62.4%. The three benchmark countries are also seen as leaders in providing employment compensated by the hour, which allows for more flexible work arrangements (Figure 3.11.13). Women in those countries are able to work during their childbearing years mainly because many shift from full time to hourly. Another noticeable difference is the widespread availability of other flexible work arrangements, including work from home. Korean women are shifting to hourly work in their 30s, but less than in peer countries, and they have less access to other flexible work arrangements.

The experiences of these countries point to the importance of developing a labor market model that caters to the needs of highly educated women whose careers are interrupted by motherhood. Hourly work may be a flexible arrangement that enables women to work while raising children, but it offers only limited career prospects. The model should therefore allow women to transition back to full time. The number and quality of hourly jobs, especially for highly educated women, should be augmented. In the Republic of Korea, hourly employment is dominated by temporary or daily work, and pay per hour is only 45.4% that of full-time workers. A broader prerequisite is to establish woman-friendly work environments with flexible hours, other arrangements such as work from home, and more and better childcare facilities. Such arrangements would encourage highly educated Korean women to combine office work with homemaking.