REPUBLIC OF KOREA

Growth moderated in 2022 as exports and investment struggled in a challenging external environment. Growth is expected to slow further in 2023 before picking up in 2024 as the global outlook improves. In 2022, inflation reached its highest in 2 decades, but it is expected to slow in line with falling rents and weaker domestic demand. The Republic of Korea (ROK) needs to address issues that arise with an aging population.

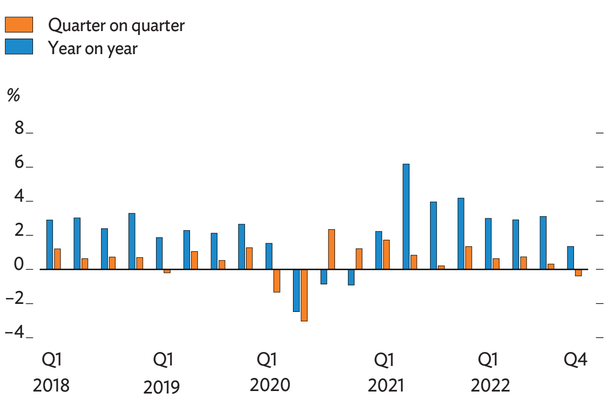
Economic Performance

GDP growth moderated from 4.1% in 2021 to 2.6% in 2022, reflecting a deteriorating global economy (Figure 2.12.1). After averaging 3.0% year on year in the first 3 quarters, growth slowed to 1.4% in the last quarter. GDP shrank by 0.41% quarter on quarter in the last quarter of 2022, more than anticipated and marking the first quarterly decline since the second quarter of 2020.

On the demand side, growth was boosted by consumption. Private consumption growth increased from 3.7% in 2021 to 4.3% in 2022 and contributed 2.0 percentage points to growth (Figure 2.12.2).

Figure 2.12.1 Quarterly GDP Growth

Growth slowed during the year.

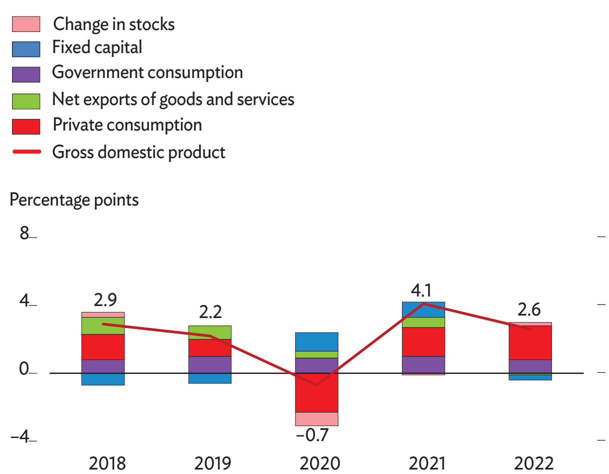


Source: CEIC Data Company.

Retail sales volume increased on better labor market conditions as the unemployment rate fell from 3.7% in 2021 to 2.9% in 2022. Additionally, the government pursued several initiatives to support consumption, including fuel subsidies and discount consumption coupons for agriculture, fishery, and livestock products. Nevertheless, government consumption contributed only 0.7 percentage points to growth, despite the implementation of pandemic fiscal stimulus.

Figure 2.12.2 Demand-Side Contributions to Growth

Private consumption continued its strong contribution to growth in 2022.



Source: CEIC Data Company.

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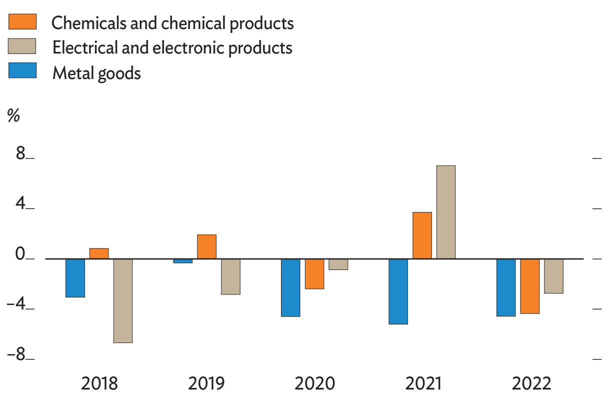
Fixed investment contracted by 0.8%, subtracting 0.3 percentage points from growth as government outlays declined by 6.2% owing to pandemic priorities. Investment in facilities reversed 9.0% growth in 2021 to contract by 0.5%, while construction investment growth remained in negative territory for a second year in a row. The 2021 housing price boom began to fade in 2022, and by the end of the year home prices were 4.7% lower than they had been at the end of 2021.

Growth in exports of goods and services slowed from 10.8% in 2021 to 3.2% in 2022. This was mainly a decline in the volume of major commodity exports—especially electrical and electronic products, chemicals and chemical products, and metal goods—as demand for ROK exports faltered (Figure 2.12.3). Imports of goods and services grew more rapidly than exports, at 3.7%, such that net exports subtracted 0.1 percentage points from growth.

Figure 2.12.3 Growth in Volume of Major Commodity Exports

Exports of major commodities faltered.

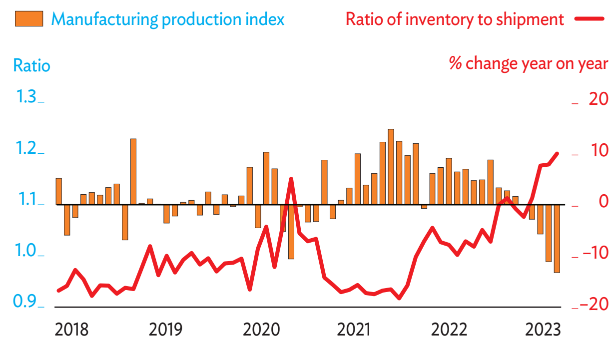


Source: CEIC Data Company.

On the supply side, services were the main contributor to growth, contributing 2.4 percentage points. Benefiting from the economy's continued reopening, wholesale and retail trade, lodging, and food services more than doubled their growth rate in 2021 to 6.8%, contributing 0.6 percentage points. After rebounding in 2021 to 6.9% expansion, manufacturing output growth slowed to 1.4% in 2022. The production of major exports such as semiconductors and petrochemicals fell on worsening global demand overall, creating a surge in inventories (Figure 2.12.4). Construction grew by 0.3% after declining for 4 years in a row.

Figure 2.12.4 Manufacturing Indicators

Inventories rose as production fell on weakened external demand.

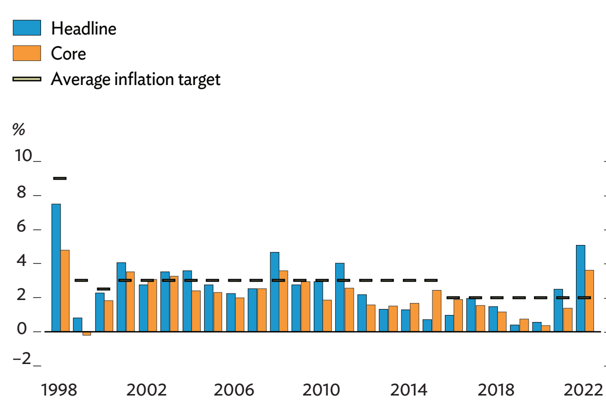


Source: CEIC Data Company.

Inflation rose to 5.1%, the highest since 1998 (Figure 2.12.5). Higher input costs and demand propelled the price increase. Import prices rose by 26%, partly reflecting ROK won depreciation. The main contributors to inflation were transportation, food, restaurants and hotels, housing and utilities, and personal care. Core inflation, which excludes food and energy, rose to 3.6%, the fastest pace since 2008. In response to the inflationary pressures, the Bank of Korea, the central bank, hiked its policy interest rate seven times during the year, raising it by a total of 225 basis points to reach 3.25% in November. As a result, bank lending interest rates have risen over the past 2 years.

Figure 2.12.5 Inflation

Inflation remained above the 2% target.



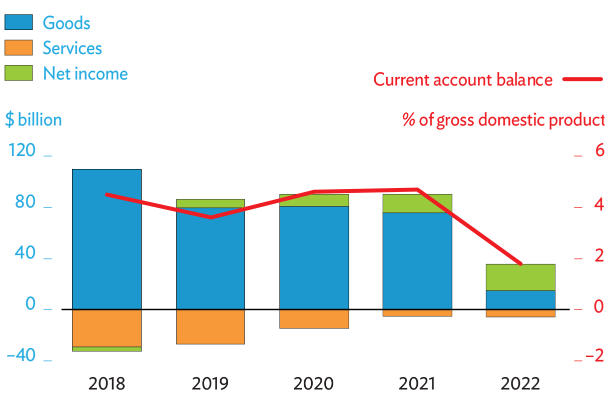
Source: CEIC Data Company.

Lending to businesses and households expanded more slowly than in 2021. Corporate bond issuance fell by 9.8% in 2022, the first decline in 7 years, as benchmark rates rose and some loan defaults and payment delays rippled through the market. Similarly, by the end of 2022, outstanding credit to households had decreased by 0.2% from 2021. As a result, domestic liquidity growth decreased from 12.9% in 2021 to 5.1% in 2022.

The current account surplus stood at $29.3 billion, well below $85.2 billion recorded in 2021 (Figure 2.12.6). This was largely a result of the narrowing of the merchandise trade surplus by 80.1% as imports rose more rapidly than exports because of high energy prices, and the widening of the net services deficit. Growth in merchandise exports was subdued at 6.3%, only a quarter of the rate in 2021 as the slowdown in the People's Republic of China (PRC) and negative growth rates in Russia and Hong Kong, China undercut growth of exports to Asia and Europe. Exports to the PRC, which takes more than a fifth of ROK exports, contracted by 4.4% as exports fell for electrical and electronic products, machinery and precision instruments, and crude materials and fuels. Net foreign direct investment and net portfolio investment weakened, pushing the overall balance of payments deficit to the equivalent of 1.7% of GDP. Official foreign exchange reserves fell by 8.6% from a year earlier to $423 billion in December 2022 but still provided cover for 7.5 months of merchandise imports. The won strengthened against the US dollar toward the end of the year, cumulatively depreciating by 6.5% in 2022 despite plunging by 17.4% in October.

Figure 2.12.6 Current Account Balance

The current account surplus narrowed in line with a decline in the merchandise trade surplus.



Source: CEIC Data Company.

Fiscal policy remained supportive of growth in 2022. Two supplementary budgets passed in February and May 2022 provided an additional W20 trillion to support small businesses and vulnerable populations, improve disease control efforts, stabilize prices, and protect people's livelihoods. Tax revenue grew by W53 trillion, from W344 trillion in 2021 to W397 trillion, thanks to improved corporate earnings. Consequently, government revenue excluding social security contributions rose by an estimated 7.2% from 2021 while expenditure increased by an estimated 13.3%. The fiscal deficit thus widened from the equivalent of 5.2% of GDP in 2021 to 7.0% in 2022.

Economic Prospects

Growth is forecast to slow to 1.5% in 2023 and rise gradually to 2.2% in 2024 (Table 2.12.1). It will be supported mainly by consumption with limited contribution from investment or exports. Consumption will, however, grow only moderately in 2023. Real household incomes will remain constrained, as real wage growth has lagged GDP growth since the middle of the 2000s. This trend is likely to continue, though slowing inflation will alleviate some of the pressure. With household debt reaching 105% of GDP and mostly borrowed with floating interest rates, the increase in the central bank policy rate by 25 basis points in January 2023 will raise household debt service expenditure. These factors and lower rental income and capital gains caused by falling property values will dampen household spending. Public consumption will be constrained by the government's efforts to cut the fiscal deficit this year. Expenditure under the approved 2023 budget of W638.7 trillion, equal to 27.3% of GDP, is 6% lower than last year's budget and is allocated mainly to public health, welfare, and employment programs, which receive 35.4%, followed by education with 15.1%, and national defense with 8.9%. To provide immediate relief to an economy suffering slow growth in exports and employment, the government aims to spend at least 60% of the 2023 budget in the first half.

Exports are projected to rise slightly in 2023 and strengthen gradually in 2024. Following sharp declines in exports, manufacturing, and services since the beginning of the fourth quarter of 2022, exports to such prime markets as the PRC, the European Union, the US, and Japan, will likely grow only modestly in

Table 2.12.1 Selected Economic Indicators, %

Growth will slow in 2023 before picking up in 2024 while inflation gradually decelerates.

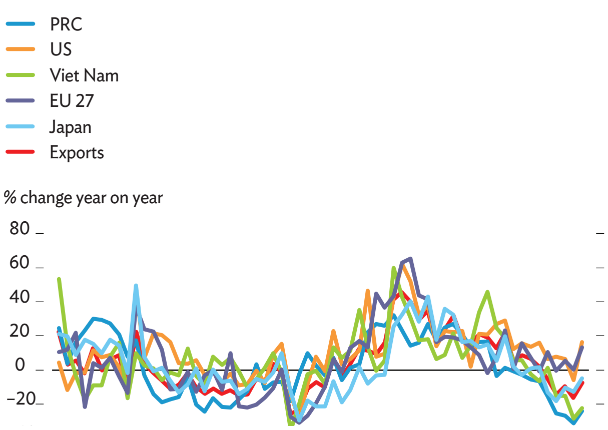
	2021	2022	2023	2024
GDP growth	4.1	2.6	1.5	2.2
Inflation	2.5	5.1	3.2	2.0

GDP = gross domestic product.
Source: Asian Development Bank estimates.

2023, given the forecast global economic slowdown. Exports were still contracting in February by 7.5% year on year, but that was improved on the previous month's 16.6% decline as exports to major destinations strengthened, indicating possible recovery in the months ahead (Figure 2.12.7). PRC demand for consumer goods and industrial parts is expected to increase this year following its exit from its zero-COVID policy, but the positive effect on the ROK economy may not be felt until the second half of the year.

Figure 2.12.7 Merchandise Exports

Goods exports may have bottomed out.



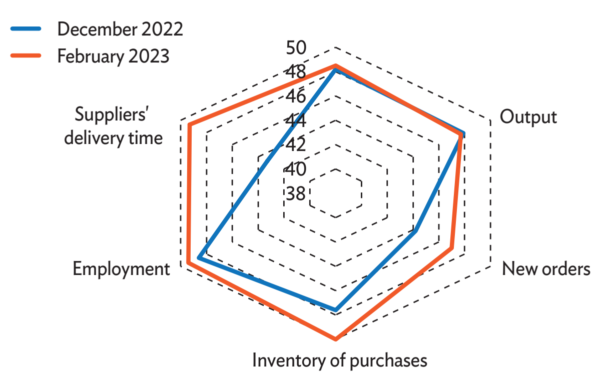
EU = European Union, PRC = People's Republic of China, US = United States of America.
Source: CEIC Data Company.

Investment growth will be subdued. Corporate investment surveys indicate that major firms in the ROK plan only modest investments in 2023 because of high economic uncertainty. The drop in exports will be reflected in production and investment as manufacturers draw down inventories. Business confidence indicators reveal unusually strong pessimism, which bodes ill for equipment investment in the first half of the year. The March business sentiment index, based on a Federation of Korean Industries survey, was 93.5, still below the 100-point threshold but up by 10.4 points from February. The composite purchasing managers' index continued to signal contraction, its reading of 48.5 in February unchanged from the previous month but up from 48.2 in December 2022 as most subindexes improved (Figure 2.12.8). Machinery orders, a good indicator of equipment investment, rose by 4.6% year on year in January after dropping by 25.2% in December 2022. Construction investment, which contracted in both 2021 and 2022, is expected to rise only marginally. A buildup of unsold houses and a decline in housing starts indicates that the housing market is heading into a downturn that will drag on construction (Figure 2.12.9). While the government will continue to ease lending requirements and real estate regulations, high interest rates will make it more difficult for consumers to reenter the housing market. Further, the recent fall in housing prices may dampen the outlook for profitability and crimp residential construction.

Inflation will trend downward. Consumer prices increased by 4.8% year on year in February, decelerating from 5.2% in January (Figure 2.12.10). Core inflation remained at 4.0% in February, indicating that underlying pressures remain high. The inflation rate has been well

Figure 2.12.8 Purchasing Managers' Index

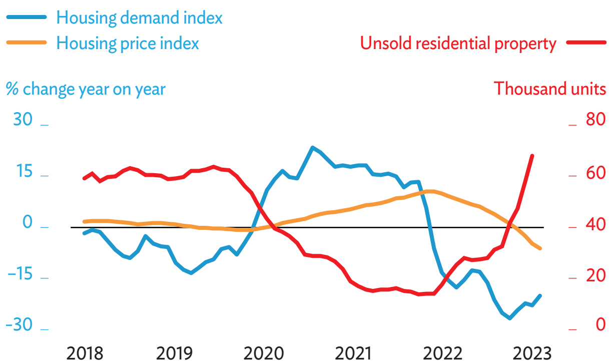
The index shows some improvement but remains below the 50-point threshold.



Note: A purchasing managers' index reading <50 signals deterioration, >50 improvement.
Source: CEIC Data Company.

Figure 2.12.9 Housing Indicators

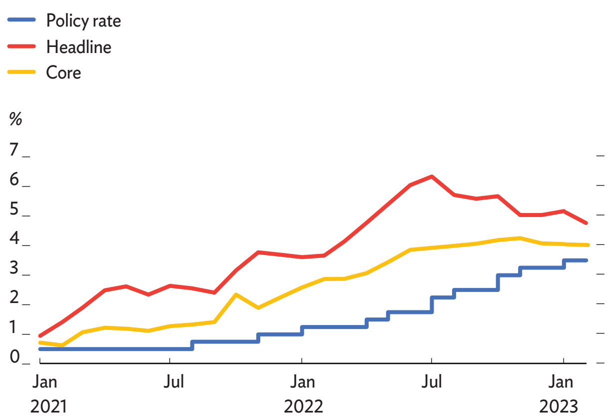
Construction will be hampered by the housing downturn.



Source: CEIC Data Company.

Figure 2.12.10 Inflation and the Policy Rate

Tightened monetary stance should support disinflation.



Source: CEIC Data Company.

above the 2% target since the fourth quarter of 2021, and bringing it down will require sustained monetary tightening. However, the weakening economic condition is expected this year. The Bank of Korea raised policy rates by another 25 basis points in January 2023, bringing it to 3.5%, before pausing in February. The biggest utility company in the nation increased electricity prices by 9.5% on 1 January. Additionally, the government reduced its tax break on gasoline that same day from 37% to 25%. These measures mean inflation is likely to remain elevated in the early months of 2023, but feed-through effects from monetary tightening in 2022 and declining rents and weaker domestic demand should dampen inflation to an average of 3.2% in 2023 and 2.0% in 2024.

Risks to the outlook tilt somewhat to the downside. Unexpectedly strong global economic growth and rapid decline in commodity prices are upside risks to the outlook. However, worsened supply chain disruption brought on by a resurgent pandemic, a prolonged Russian invasion of Ukraine, or any sign of delay in PRC economic recovery would be detrimental to growth. The major domestic risks to the outlook are rising public and private debt, which could raise debt service costs, reduce consumption more than anticipated, and generate financial instability.

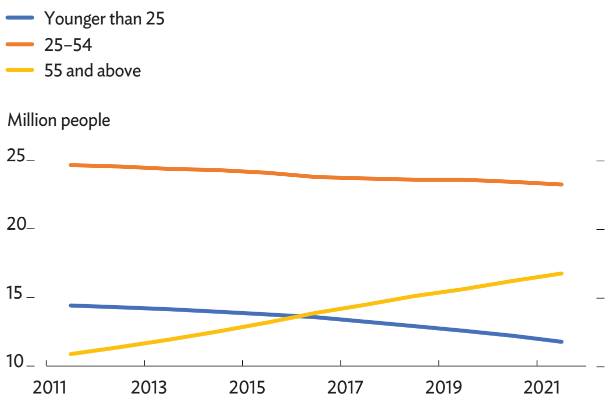
Policy Challenge— Responding to an Ageing Population

The population is getting older, with implications for growth potential. There were 14.4 million people in the ROK under the age of 25 in 2011 but only 11.8 million in 2021 (Figure 2.12.11). Also, the portion of the population aged 25–54 has decreased by 1.4 million, but the number of those aged 55 and over has increased from 11.0 million in 2011 to 16.7 million in 2021. Demographic projections show the ROK among the world's fastest aging economies, with a high percentage of elderly comparable to Japan and the PRC. According to estimates by Statistics Korea, 17.5% of the population was over the age of 65 in 2022. This will rise to 40.1% by the 2050. By then, the old-age dependency ratio, or the population aged 65 or more over the population aged 15–64, is expected to be 79% (Figure 2.12.12). With a fertility rate of 0.84 children per woman, the lowest in the world, and rising longevity thanks to its national health-care system and improving quality of life, a fast-aging population will deprive the country of human capital and stall long-term growth potential. The labor force will grow more slowly as the population ages, and within 20–30 years it may even start to decline. Insufficient labor will undermine productive capacity and competitiveness.

Fiscal sustainability could face a significant structural challenge as the elderly population grows rapidly. A declining population of tax-paying workers can reduce government revenue even as government spending on programs for the elderly, particularly health care, places a persistent burden on public finances. The growing debt burden could be inflationary and challenge public financial management,

Figure 2.12.11 Inflation and the Policy Rate

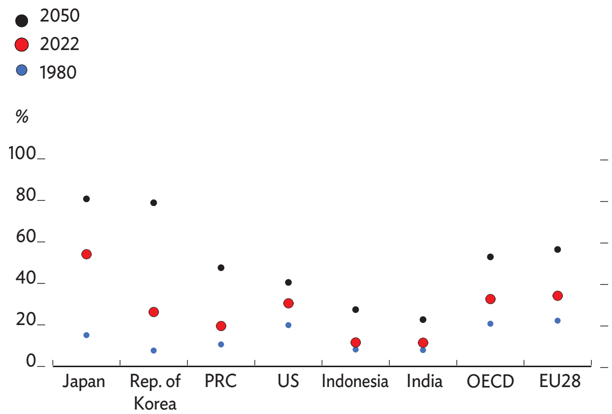
The Republic of Korea's population is aging quickly.



Source: CEIC Data Company.

Figure 2.12.12 Inflation and the Policy Rate

The dependency ratio is expected to rise further in the Republic of Korea.



EU = European Union, OECD = Organisation for Economic Co-operation and Development, PRC = People's Republic of China, ROK = Republic of Korea, USA = United States of America.

Note: The old-age dependency ratio is the number of individuals aged at least 65 per 100 people of working age, or 20–64.

Source: OECD. 2023. Old-Age Dependency Ratio (indicator).

including tax collection and budget allocation to other important development priorities, such as technological improvement and productivity growth, and climate change mitigation and adaptation. Policy actions to mitigate a labor shortage include encouraging automation, offering incentives to attract qualified migrant workers, and initiatives to keep the elderly on the job.

Ongoing efforts to increase employment among the elderly show promise. The Senior Employment and Social Activity Support Program helps elderly job seekers maintain their physical and emotional well-being and their social and economic viability. The program, which is run by the Korea Labor Force Development Institute for the Aged, aims to provide reliable sources of income for the elderly while helping them to save money on their medical expenses. Additional policies and coordination of the public and private sectors are needed to enhance the prospects of older workers in the labor market through upskilling, work incentives, and enhancing job quality with decent incomes and work environments. In Singapore, for example, the government has a national program called SkillsFuture that gives every Singaporean aged 25 and older a $500 opening credit that can be used to take skills courses. In Japan, the government invests in aged-care industries to meet the needs of an aging population while lowering the cost of care.