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CONTENTS

OVERVIEW AND MACROECONOMIC ISSUES

A MACROECONOMIC OVERVIEW OF THE KOREAN ECONOMY

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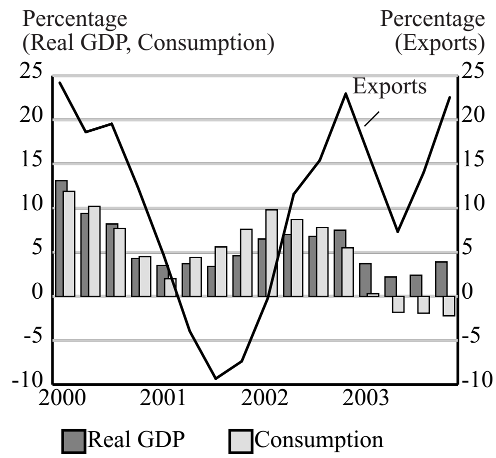
Introduction

The Korean economy exhibited a disappointing performance in 2003. In the second quarter of 2003, the growth rate of real gross domestic product (GDP) was 2.2 percent (year-on-year), a rate even lower than the rate of 3.4 percent in the third quarter of 2001 when the economy was in the middle of a recession. In the third quarter of 2003, the economy recovered slightly, with a growth rate of 2.4 percent. That rate, however, is still too low for an economy like Korea's. Except for the depression caused by the oil shock in 1980 and the Asian crisis in 1998, the Korean economy had not experienced a growth rate below 4 percent since 1971. This weak growth has been contrary to world trends, which are toward recovery. So far, it seems that Korea has not taken full advantage of the opportunities generated by the recovery of the world economy, mainly the recovering U.S. and Japanese economies.

Consumption Losing Vigor

The fact that the external environment is improving as part of the recovering world economy implies that the current underperformance of the Korean economy stems from internal problems. Korea's first problem is severe contractions of private consumption and facility investment. ***Figure 1*** shows that the growth rate of private consumption has been slowing since 2002, with growth rates of –1.8 percent, –1.9 percent, and –2.2 percent in the second, third, and fourth quarters of 2003, respectively. Aside from the period of the financial crisis in 1998, this was the only time in South Korea's history that private consumption contracted for three consecutive quarters. Even the oil shock of 1980 saw private consumption at a stable 5 percent growth.

Figure 1: **Korea's Real GDP, Consumption, and Exports, 2000−2003**



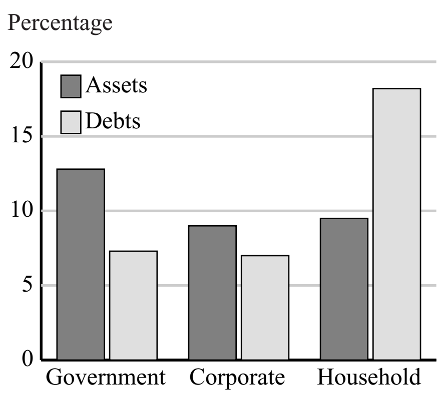
Source: Bank of Korea,
http://ecos.bok.or.kr/EIndex_en.html.

Since the second half of 2000—the beginning of the recession—the government has been decreasing the interest rate to prevent the economy from falling into full-blown depression. The Bank of Korea (BOK) has cut the target call rate seven times since October 2000, when it was 5.25 percent, and it has been stable at 3.75 percent since last July. This is probably the lowest target call rate that the BOK has ever set. Thanks to the expansionary monetary policy, which was relatively effective, private consumption could continue to grow even during the recession. Low interest rates made it possible for consumers to keep acquiring durable goods such as cars and housing, and consumption was supported by higher debt. Most extra debt induced by low interest rates was in the form of loans secured by houses as collateral rather than signature loans. Durable goods and the housing markets were the final destinations of the funds flowing out of the stock market and the banking sector, where earnings on these funds had been low.

The upward trend of private consumption caused by the expansionary monetary policy lasted for the whole of 2001, but it started to disappear in 2002. It turned out that the household sector had accumulated too much debt in 2001 and 2002, and the burden of repaying these debts became enormous. Although the interest rate is still low, the absolute size of household debt became so large that the burden of repaying interest and principal began to restrict consumption.

Figure 2 shows that the household sector has been the major accumulator of debts during the past three years. Since the recession started in the second half of 2000, the average growth rate of debt in the household sector has been 18.2 percent—two times higher than in the corporate and government sectors. At the end of 2002, the ratio of household debt to GDP reached 84.1 percent, the highest level to date, while debt has been stabilizing in the corporate sector owing to the corporate restructuring that followed the Asian financial crisis.

Figure 2: **Average Rate of Growth of Assets and Debts of the Government, Corporate, and Household Sectors in Korea, 2000 (third quarter)−2003 (third quarter)**



Source: Flow of Funds, Bank of Korea, www.bok.or.kr/.

In addition to the low interest rate, indiscreet use of credit cards has been another factor that has accelerated debt accumulation in the household sector since 2000. The credit card market was still in an early stage of growth in Korea, and the government, which wanted to boost private consumption, stimulated the credit card market by deregulating cardholder requirements and card issuing processes, and by providing tax benefits for card users. With these policy incentives, credit card companies neglected risk management and vigorously increased their market shares simply by issuing as many credit cards as they could.

The credit card market has grown rapidly during the past few years and is expected to grow more in the future. However, this growth-oriented strategy is acceptable only when the economy is booming; in a recession it inevitably results in a higher delinquency rate and induces high rates of individual bankruptcies. The high delinquency rate is now threatening the financial stability of credit card companies in Korea. Credit card companies are now rapidly reducing their credit to consumers, another reason for the recent drop in private consumption.

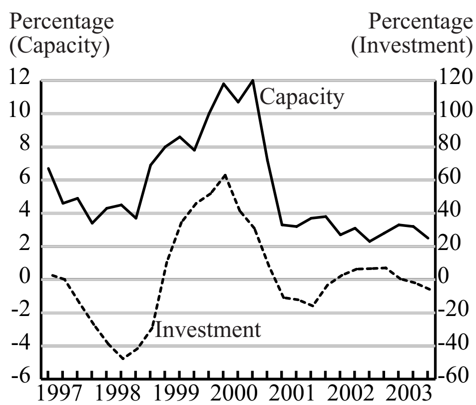
Future consumption looks positive in the longer term, however. The growth rate of net wealth in the household sector turned positive again in 2003 after having fallen since 1998 to below the positive cutoff in 2002. This implies that the household sector adjusted its balance sheet in 2003, an adjustment that is expected to continue in 2004 because consumers are serious about reducing their debt burden. This adjustment will be made through tightening purse strings. As long as consumers feel insecure because of debt, they will reduce consumption and increase savings; this implies that it will take some time for private consumption to regain its growth trend. Thus, private consumption will probably not show much improvement in 2004 because of the savings-consumption adjustments under way. Private consumption may be recharged in 2005 after two years of savings-consumption adjustment, resulting in higher net wealth in the household sector.

Investment Falling

The falling consumption in 2003 was a relatively new phenomenon compared with investment behavior. For the past four years, facility investment has been falling, and the absolute level of facility investment is somewhere around the level of 1995. Between 1995 and the third quarter of 2003, real GDP increased 42 percent while real facility investment rose only 0.3 percent. Because of depressed investment, the growth of manufacturing capacity is also slowing down.

There are several problems with investment behavior in Korea. The first problem is that new investment to improve productivity is not high enough (***Figure 3***). In 2003, new facility investment to improve productivity amounted to only 30.1 percent of total investment; in Japan it was 42.0 percent. Most investments were made for maintenance purposes. This type of investment behavior will not do much for robust and continuous economic growth in the future. The second problem is that the portion of capital goods imported from Japan continued to increase; thus the dependence on Japan for capital goods has deepened. The bilateral trade deficit with Japan reached an all-time high of $18 billion in 2003. Third, the size of investment projects in the future will be smaller than investments of the past.

Figure 3: **Korea's Investment and Manufacturing Capacity, 1997–2003**



Source: Korea National Statistical Office.

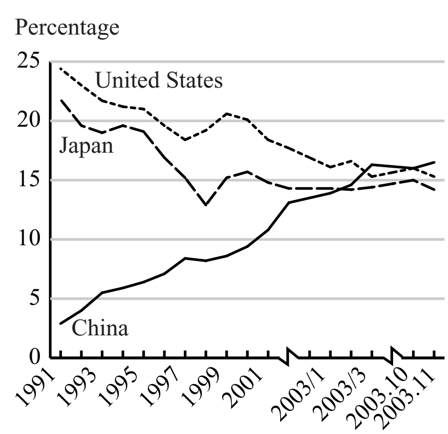
The Korean economy had been growing by executing large investment projects in industries such as automobiles, steel, shipbuilding, and semiconductors. This large-scale investment behavior was supported by large loans provided by banks explicitly and implicitly controlled by the government. However, the ownership of Korean banks has changed greatly since the Asian crisis of 1998. As a result of the restructuring of financial institutions during the past five years, foreign investors predominate in the ownership of most major Korean banks. Therefore, it is expected that banks controlled by foreign investors will be more cautious in their choices of investment projects than the banks were in the old days when they were influenced by the government. Banks controlled by foreign investors will emphasize project profit analysis and risk management more than sales figures and the contribution to the economic growth of Korean economy. Therefore, it is less likely that investment will again be the main engine of growth as it was in the 1970s and 1980s.

Robust Export Growth and Improved Current Account

Unlike private consumption and facility investment, which showed negative growth, exports performed robustly, with annual growth of at least 16 percent forecast; the growth of the Korean economy in 2003 was based heavily on exports. The recovery of the world economy has generated higher demand for Korean products such as semiconductors, electronics, cars, and wireless communication devices. The world economy is expected to recover further in 2004, and, thus, the growth trend of Korean exports is expected to continue in 2004, although the Korean *won* will face upward pressure with respect to the dollar.

Exports to China continued to rise rapidly in 2003 (***Figure 4***). The annual growth rate of Korean exports to China reached 47.8 percent for 2003. In 2003, exports to the United States, the European Union, and Japan also showed very strong growth, ranging from 10 percent to 20 percent over 2002 levels. In fact, the rapid increase in exports to China finally made China Korea's number one trading partner in 2003,

Figure 4: **Korea's Trade (as a percentage of Korea's total volume of trade) with China, Japan, and the United States, 1991–November 2003**

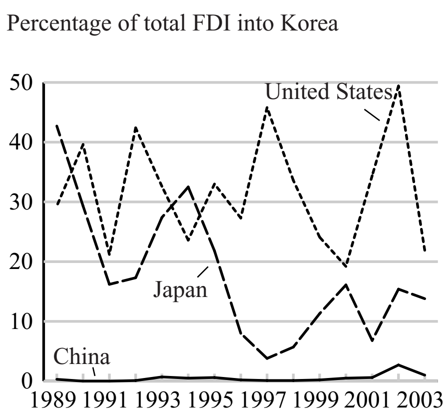


Source: Korea National Statistical Office.

overtaking the United States, which had been in first place for the past several decades. The rapid growth of the Chinese economy leads to the expectation that, over the coming decade, merchandise trade with China will grow more than will trade with the United States. Nevertheless, the economic relationship between Korea and United States will continue to be important for both countries in the area of services trade and foreign direct investment (FDI).

Figure 5 shows that the United States was the largest investor in Korea and is likely to retain that position in the future although FDI into Korea was generally low. There is virtually no direct investment coming from China, and it is unlikely to increase for the next 10 to 20 years. For the Korean economy to keep growing and upgrading its economic structure, it is crucial for Korea to deepen its trade with the United States in the area of services and knowledge-oriented industries.

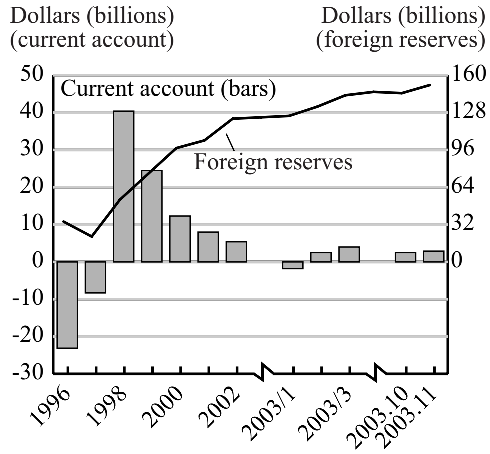
Figure 5: **Foreign Direct Investment into Korea, 1989−2003**



Source: Ministry of Commerce, Industry, and Energy.

In 2003, growth of imports in Korea was 9.7 percent—well below export growth, which resulted in a larger surplus in current account (***Figure 6***). The current account recorded a surplus of $12.3 billion in 2003—more than double the surplus recorded in 2002. As a result of a continuing current account surplus since 1998, foreign reserves now exceed $150 billion, and net foreign assets exceed $40 billion. The international financial community seems to put high value on the improved external position of Korea. Risk premiums on Korean bonds continued to fall in the second half of 2003 and have recently stabilized at a level almost equal to the premium imposed on China. Risk premiums rose greatly in early 2003 when the nuclear crisis with North Korea and an accounting scandal involving SK Global figured prominently.

Figure 6: **Current Account and Foreign Reserves in Korea, 1996−2003**



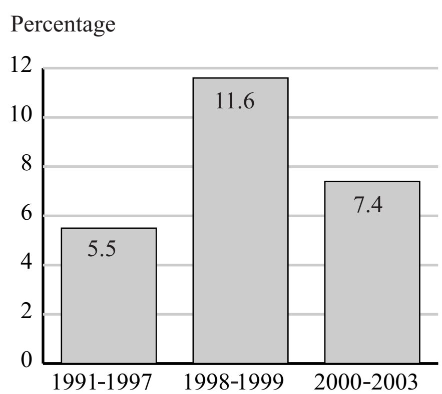
Source: Balance of Payments, Bank of Korea, www.bok.or.kr/.

Mild Inflation, Not Enough Jobs

In general, inflation was mild in 2003. Although the consumer price index (CPI) inflation rate was 3.6 percent in 2003, which is a bit higher than the 2.7 percent of 2002, it is 2 percent lower than the average inflation of 1990s. First, the economy has lost some steam. Consumption and investment slowed rapidly in 2003; this means there is still a lot of room for the economy to expand without incurring any demand-side pressure on inflation. Korea had no overheating in the economy that could have resulted in higher inflation. Inflation was caused solely by cost factors in 2003, and this trend will continue in 2004. Geopolitical risk in early 2003 resulted in high oil prices, but most of the risk involved with the war in Iraq dissipated in the first half of 2003. Oil prices then stabilized also. Therefore, inflation caused by higher oil prices was limited. Even though Korea experienced higher oil prices in 2003, the Korean *won* was appreciating at the same time. The appreciating Korean *won* brought down import prices, which contributed to low inflation in 2003. Oil prices will be further stabilized in 2004 as oil production in Iraq increases and the appreciation of the Korean *won* continues. These factors will limit inflation to below 3 percent although the Korean economy is expected to recover in 2004.

Korea's overall rate of unemployment was 3.4 percent in 2003, which does not look that bad compared with the 7 percent rate in 1998 when Korea was suffering from the Asian financial crisis. However, the labor market does not appear flexible enough to resolve many problems related to job creation. Youth unemployment is increasing. ***Figure 7*** tells us that the rate of youth unemployment was 2 percentage points higher on average for the past three years compared with the precrisis period. Increased youth unemployment is a new phenomenon in Korea. In the past, when the Korean economy was growing at 8 percent on average, young college graduates found it easier to get jobs. The unemployment rate for college graduates now stands at around 6.7 percent, much higher than the overall unemployment rate. This situation was simply unthinkable in the "good old days." The economy seems to be losing its ability to create new jobs to cover new job seekers. In 2001, economic growth of 1 percent was able to create 133,000

Figure 7: **Average Rates of Unemployment for Korean Youth, ages 15−29, 1991−2003**



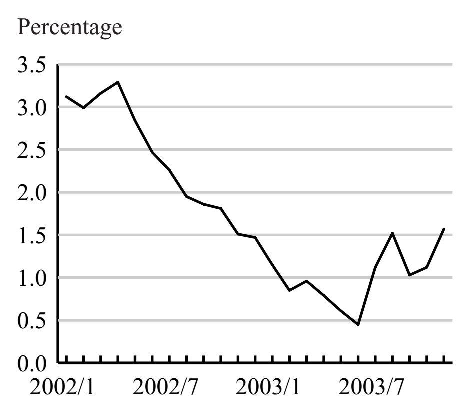
Source: Korea National Statistical Office.

new jobs, but the ability to create new jobs deteriorated in 2002 and 2003. As a result, 1 percent growth could create only 35,500 new jobs in 2003. The decrease in new jobs aggravated the job market situation, especially for young people. The deteriorating capability of the economy to create new jobs is believed to be caused by structural changes that were enforced in most industries after the financial crisis. The inflexible labor market is believed to be another factor that has worsened employment for the younger generation. Strong labor unions in Korea have been successfully fighting to protect jobs for union members, which means that it has become more difficult for new entrants to the labor market to find jobs. Therefore, it is not likely that the youth unemployment problem will be easily resolved in the near future.

Recovering Confidence in the Financial Market

Several indicators have recently shown that the financial market has been recovering its confidence in the Korean economy. The spread between long-term and short-term interest rates started to narrow beginning in early 2002 (***Figure 8***); this trend continued until the second quarter of 2003, reflecting the financial market's disappointment with the delays in economic recovery and the market's pessimistic expectations regarding economic revival in the near future. This spread finally began to widen in the fourth quarter of 2003, with the rise of long-term interest rates. This implies that the financial market is becoming more optimistic about the possibility of economic recovery in 2004 and thereafter. Therefore, in general, long-term interest rates will maintain an upward trend throughout 2004, while short-term interest rates will continue to stay low because the government will

Figure 8: **Spread between Long-Term Interest Rates and Short-Term Interest Rates in Korea, 2002−2003**

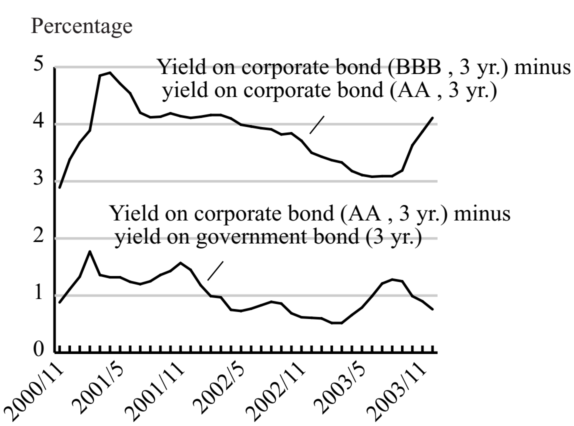


Source: Korea National Statistical Office.

Note: The spread equals the yield on 10-year government bonds minus the interbank call rate maintain its expansionary monetary policy in order to secure economic recovery.

Optimism in the financial market becomes more evident when interest rate spreads are examined (***Figure 9***). Spreads between corporate bonds and government bonds were widening in the first half of 2003, reflecting flight to quality caused by higher geopolitical risk involving the war in Iraq and nuclear conflicts with North Korea as well as the scandal involving the SK Group. But this spread began to narrow beginning in August 2003 as geopolitical risk diminished with the official end of the war in Iraq. While spreads between corporate bonds and government bonds narrowed because of the diminished flight to quality, spreads between non–blue chip corporate bonds and blue chip bonds have been widening since the third quarter of 2003. This implies that, while flight to quality caused by geopolitical risk has diminished, flight to quality in the financial market caused by insolvent credit card companies has intensified. Risk premiums on non–blue chip corporate bonds will continue to rise in 2004 unless the problems of credit card companies are resolved.

Figure 9: **Credit Spreads in Korea, 2000−2003**

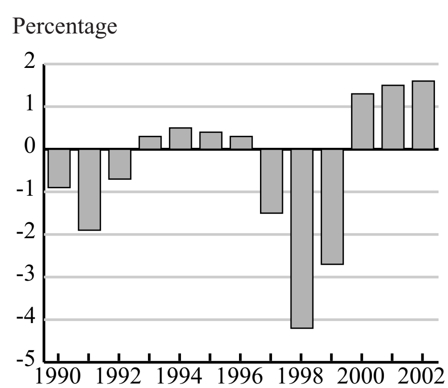


Source: Bank of Korea, www.bok.or.kr/.

Recently, however, it was announced that the government-owned Korea Development Bank will take charge of LG Credit Card, which is the largest insolvent credit card company, and execute an intensive restructuring program to restore profitability. This is good news for the financial market because most of the uncertainties related to credit card companies have been eradicated. Therefore, in general, the bond market will be more stable in 2004 than it was in 2003.The overall trend of the Korean *won* in 2003 was appreciation against the dollar. This was mainly caused by the strong trend of dollar depreciation that was caused inter alia by a large U.S. current account deficit. There were many ups and downs in the *won*-dollar exchange rate, however, because the Korean economy did not do well in 2003. Whenever the nuclear conflict flared up or an accounting scandal broke out, the Korean *won* depreciated against the dollar, revealing the vulnerabilities of the Korean economy. It is expected that the appreciating trend of the Korean *won* against the dollar will continue in 2004, and the *won*-dollar exchange rate is expected to be approximately 1,170 on an annual average. The average *won*/dollar rate was 1,192 in 2003.

Figure 2 showed that the government sector has been improving its balance sheet since the Asian crisis: the government sector has accumulated assets faster than it has accumulated debts, even though the economy stayed in recession. This implies that fiscal policy was not expansionary in Korea, even in the recession period. As a result of the conservative stance on government finance, the government is experiencing a fiscal surplus (***Figure 10***). If the economy continues to recover in 2004, tax revenue will rise and the fiscal surplus will grow; it may exceed 2 percent of GDP in 2004.

Figure 10: **Korea's Fiscal Balance Relative to GDP, 1990−2002**



Source: Ministry of Finance and Economy.

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