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OVERVIEW AND MACROECONOMIC ISSUES

ECONOMIC OUTLOOK FOR KOREA IN 2005: FIRMER DOMESTIC SPENDING

by Huh Chan-guk

Many observers abroad expressed bewilderment in 2004 about the distinctly pessimistic economic outlook and sentiment among Koreans that did not seem to be consistent with an economy that was expected to grow nearly 5 percent for the year. Two important factors seem to have been part of the explanation. First, growth in output during the past couple of years has come almost exclusively from robust external demand. Furthermore, strong growth in exports has failed to dispel the big chill that had wrapped around domestic spending during the past two years.

Second, deep-seated worries have existed about whether the Korean economy could regain its pre-1997-crisis vibrancy and growth potential. Capital spending, too much of which was viewed as evidence of reckless corporate expansion in the pre-1997 period, has slowed drastically in recent years. Lack of new capital formation, in turn, has meant lower growth potential. This new trend is due to a significant change in corporate behavior since the 1997 crisis. The corporate sector, ever the workhorse of Korea's rapid growth, has been made the key culprit for the 1997 crisis by the government and has been placed on an intrusive probation for past wrongdoings, both real and imaginary. Naturally, businesses are now being too careful. The overall trend in employment conditions has also ratcheted down. Given such developments, it may be natural that consumers have an uneasy feeling about the future.

These two factors should greatly influence the tone and tenor of Korea's economic outlook in 2005. There is widespread consensus, for example, that growth in external demand will slow down compared with previous years. Consequently, this year's growth will depend largely on the expected recovery in domestic spending. An improvement in consumer sentiment could help consumption, which has contracted for two consecutive years since 2002—the year of the credit card–financed consumption boom. Tentative signs show that consumers are starting to spend again in early 2005. A perceptible rise in investment will not only boost domestic demand and thereby help raise the year's growth rate, but also should help to allay worries about growth potential. Although many businesses are in enviable financial positions in the wake of their recent robust export performance, an increase in capital spending is likely to be somewhat limited. The remainder of this paper, which begins with a macroeconomic outlook, presents in overview some key issues surrounding the Korean economy in 2005.

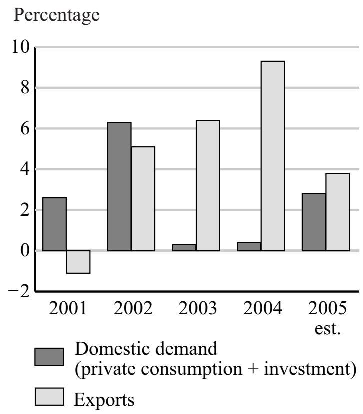
Economic Outlook: A Recovery in Domestic Demand?

In 2005, largely because of slower export growth, the Korean economy is expected to record growth of approximately 4 percent, which is somewhat slower than that of 2004. However, the composition of growth is more likely to be balanced, with both private domestic and external demand equally contributing to growth. This will be a remarkable departure from the pattern seen during the past two years. ***Figure 1*** shows how growth was driven by export growth during 2003 and 2004.

Exports are expected to slow . . .

As the current recovery of the U.S. economy matures, Korea's export growth is expected to decelerate noticeably this year from the breakneck pace of 30 percent in 2004. Prospects for the continuation of 2004's long-awaited recovery in Japan are tentative. Odds for upside surprises in the European Union and the surrounding region appear slim. A consensus seems to anticipate that the world economy will grow more slowly in 2005 (at a rate of less than 4 percent) compared with 2004 (a rate of approximately 4.5 percent).

Figure 1: **Contribution to GDP Growth from Private Domestic Demand and Exports, 2001–2005 (est.)**



Sources: Bank of Korea, http://ecos.bok.or.kr/EIndex_en.html; and Korea Economic Research Institute, http://www.keri.org/eng/index_eng.asp.
Note: Fourth quarter 2004 and 2005 data are based on Korea Economic Research Institute projections.

In addition, two key factors related to China, which since 2003 has emerged as Korea's main export market on a par with the United States, are expected to affect export performance this year. One is the issue of how well the Chinese authorities engineer a soft landing of its economy in 2005. If efforts to cool China's economy fail, which in turn leads to a serious recession, China's demand for Korean industrial primary and intermediate goods that make up the bulk of Korea's exports to China would be adversely affected. Korea's export growth would be further slowed, and the overall growth projection for 2005 could be even lower.

The second factor is the renminbi. Revaluation of the Chinese currency, long anticipated, could have serious repercussions for Korea's economy, depending on when it takes place and the extent of the revaluation. In principle, renminbi revaluation should boost the price competitiveness of Korean exports vis-à-vis Chinese exports in the world market. Such a positive consequence is expected to be insignificant, however, compared with a more visible negative consequence that is expected to arise from intensified pressure on the exchange value of the Korean *won* in the wake of the Chinese revaluation. If the resulting appreciation in the Korean *won* compared with the U.S. dollar is large enough, the resulting adverse impact on the price competitiveness of Korea's exports in general will overwhelm any positive gain from the stronger Chinese currency. The approximate 20 percent appreciation since late October 2004 of the Korean *won* compared with the U.S. dollar should have the salutary effect of bleeding off a buildup of potentially explosive pressures.

. . . while worried consumers are finally expected to increase spending.

For domestic demand, the outlook for 2005 is more positive than it has been for the past several years. Private consumption, which makes up about 50 percent of Korea's gross domestic product (GDP), is finally expected to reverse its falling trend of the past two years. Private consumption fell for two consecutive years by about 2 percent and 1 percent, respectively, while the national income (or GDP) rose approximately 3 percent and 5 percent in those years in real terms. Such a divergence is almost anomalous, given that close coherence between the two is a time-honored macroeconomic relationship. The bursting of the consumer credit bubble in 2002 could largely explain the sharp cutback in consumption in 2003; however, the scope of consumer credit problems has remained in check since then. The financial condition of households seemed to have improved perceptibly by late 2003, according to flow of funds data; thus, additional factors are needed to explain why consumers continued to hold their purse strings so tightly closed throughout 2004.

There are two likely causes for consumers' reluctance to spend; both have worked to raise the level of uncertainty and anxiety and thereby depress consumer sentiment. The first is weak job creation in Korea. This trend, coupled with continued downsizing by businesses and large banks, appears to have dampened consumer sentiment. Growth in disposable income has slowed and, at the same time, has raised job insecurity; this, in turn, has encouraged precautionary savings by those who currently have jobs.

The second factor has to do with uncertainties originating from the noneconomic sectors. There seems to be fundamental disagreement, or ambiguity, among the general population and politicians about the extent, as well as the strength, of the mandate of the current government to effect changes. Many in the government and the ruling party think they have carte blanche to implement a range of initiatives, some of which have proved quite controversial.[1] It has not been uncommon to see loud protesters from numerous interest groups clogging already heavy traffic in downtown Seoul during the past couple of years. One cannot blame consumers for their uneasy feelings about adverse effects of such bitter divisiveness and splintering on the national psyche, effective economic management by the government, and the Korean economy's ability to retain its growth momentum going forward. These same concerns appear to have contributed to depressing investment sentiments.

Other developments, however, augur well for a recovery in consumption in the near term. The first is the indication visible from flow of funds data that households have progressed enough in repairing balance-sheet problems. The second is the gradual but steady improvement in the job situation during 2004. Approximately 389,000 new jobs were added in 2004, an impressive improvement compared with 2003, which recorded only 44,000 new jobs. There are tentative signs in early 2005 that consumption is regaining strength. Consumption is expected to rise about 3.5 percent, slightly lower than national income or real GDP.

Cash-rich businesses are expected to expand capital spending somewhat . . .

Owing to brisk export growth, pressure on the manufacturing sector's capacity built throughout 2004. At the same time, the financial condition of manufacturing firms perceptibly improved in 2004. According to an analysis by the Bank of Korea (BOK) published in February 2005,[2] the profit-to-sales ratio of manufacturing firms increased to 8.5 percent in 2004; this ratio in both 2002 and 2003 was 4.7 percent. A big part of this jump was due to a surge in the profitability of Korea's information technology (IT) sector businesses (the ratio in IT businesses was 17.5 percent, but in non-IT businesses the ratio was 6 percent). BOK data show that the average profit-to-sales ratio of manufacturing firms for 2002–04 was 6.0 percent, about three times higher than the comparable figure for 1991–96. A big part of the increase has been due to the lowering of businesses' financing costs—much lower interest rates as well as leverage ratios—during the same period, a fact that has helped to dampen unfettered enthusiasm.

One key development that seems to have helped brighten the general business atmosphere and investment sentiment is the visible change during 2004 in the government's attitude toward excessive collective action by labor unions. This is quite a significant development because the surge in militant collective actions by labor and other interest groups in 2003—the first year of the current government—had substantially raised the anxiety levels of businesses. If this change is sustained going forward, it will substantially enhance the investment environment in the near term.

Firmer domestic consumer demand is expected to provide support for businesses' capital spending although investment-related indicators are not unanimous. Imports of machinery have grown approximately 20 percent year-on-year in recent quarters. Also supporting this projection is the fact that growth in investment has been weaker as signaled by the relatively high capacity utilization rate and strong export performance seen in 2004. Facility investment (purchases of equipment and machinery) is forecast to continue at an 8 percent level of growth, a slightly higher pace than 2004's approximately 5 percent.

. . . but construction investment is expected to lag in 2005.

Construction investment in recent years has made up about 20 percent of GDP, thus outweighing facility investment's share of about 10 percent; construction investment was the only component of private domestic demand that until the second half of 2004

1. Examples include the government's attempt to construct a new administrative capital, a project that the Korea's constitutional court in October 2004 ruled had not followed the proper legal procedure, and the ruling party's attempts to repeal the National Security Law that prohibits unauthorized contacts with North Korea and any pro-North Korean activities. Despite past abuses of this law by autocratic former governments, surveys indicate limited support among the general public for the repeal.

2. "Changes in Corporate Profitability Structure and Implications (in Korean)," press release (Seoul: Bank of Korea, 1 February 2005), www.bok.or.kr.

showed noteworthy growth. The slowdown in construction in 2004, caused partly by the government's measures to check occasional sharp rises in real estate prices, decidedly contributed to the slump of domestic demand. At the end of 2004, however, building orders as well as building permits, both leading indicators for the sector, showed a distinct uptick, which suggests that the construction sector might contribute—although only by a little—to growth and expected recovery in domestic demand in 2005. Expansionary fiscal policy measures planned for 2005 are expected to provide some boost to this sector.

Inflation will not be a big problem this year.

High prices for oil and other key commodities in world markets have put upward pressures on prices in Korea since early 2004. Such external factors have been countered by the lack of strength in domestic demand and attendant inflationary pressures. The negative output gap that had built up during the past couple of years still remains. The strengthening exchange value of the *won* also should contribute to price stability by reducing upward pressures from external sources. The expected inflation in consumer prices of approximately 3.2 percent in 2005 is lower than the inflation rates of the past two years.

Banks are still cautious but interest rates are heading upward.

Market interest rates have dropped, and they stayed at historically low levels throughout 2004. Until the beginning of 2005, bank deposits surged, while banks' credit extension has been sluggish owing to a lack of demand for loans by businesses, particularly businesses that have done well on the back of strong external demand during the past two years. At the same time, many small- and medium-size enterprises (SMEs) are reportedly having funding difficulties. Especially adversely affected are SMEs whose businesses are domestically oriented.

Korea's banking sector—the main financial artery (in comparison with direct capital markets) to businesses small and large—is still undergoing consolidation. In the years immediately following the 1997 financial crisis, bank restructuring meant a reduction in the number of banks by either the closure of insolvent banks or the absorption of insolvent banks by healthy banks. The current consolidation phase again entails mergers and acquisitions, but now they are taking place more because of banks' strategy and competition. Another notable change in the banking sector has been that two out of eight major banks have been taken over by big-name foreign banks. Further consolidation cannot be ruled out, as competition is sure to heat up soon.

The banking sector is showing at least two distinct signs of an industry in flux. One sign is that the sector is still very sensitive to risks. It is difficult to blame midlevel managers for refraining from making risky loans, the failure of which could quickly end their job tenure, because banks are still in a downsizing mode. In addition, top management is realizing the virtue of holding government bonds rather than making risky loans in a low-interest-rate environment and weak economy. The second sign is that, despite the credit card–financed boom and bust of 2002, the banking sector is still focused on credit extension to the household sector, where creditworthy borrowers still remain, as consumer lending in Korea began in earnest only about five years ago.

Interest rates at the long end of maturity have drifted upward since the beginning of 2005. The yield on three-year government bonds went up in early February 2005 by close to 1 percentage point, from the low 3 percent range seen in late 2004. Because few observers expect a burst of inflation in the immediate future, this updrift suggests a market anticipation of a rise in demand for funds. Stock prices also have risen rapidly since late 2004. In a period of about three months, ending in mid-February 2005, the KOSPI—the Korean stock price index—rose close to 10 percent.

Expect some support from fiscal policy but less from monetary policy.

In 2004 the government recognized the seriousness of the doldrums in domestic demand and planned for somewhat expansionary fiscal measures for 2005. First, the central government's budget for 2005 (the general as well as the special account) was set at 167.3 trillion *won* (approximately $150 billion), about 7 percent larger than the 2004 budget (not including supplements). The front-loading of fiscal outlays is already planned, and, if past practices are any guide, the government is likely to implement additional midyear budget supplements if the economy does not pick up. Small tax cuts—1 percent on personal income, 2 percent on corporate profits, and the removal of special excise taxes on some items—are also to be implemented this year. These measures pose little threat to Korea's fiscal soundness because the national debt-to-GDP ratio is expected to remain below 30 percent in 2005. The debt-to-GDP ratio for 2004 was 26.2 percent, well below the average of 76 percent for Organization for Economic Cooperation and Development (OECD) countries. In addition, starting in the second half of 2005, the Korean government is implementing various measures to expand the scope of participation by private capital as well as public pension funds in various social overhead capital (SOC) projects.

In the area of monetary policy, the short-term policy interest rate was lowered twice in 2004, each time by 0.25 percentage points; the first decrease took place in midyear after about one year—since July 2003—without change. Given the degree of apparent weakness in aggregate demand and in domestic spending, in particular, and the relatively tame inflation trend during that period, the BOK's timidity seemed a little baffling. Makers of monetary policy are likely to be more reluctant to lower the policy interest rate as signs of a stronger economy become more visible. Long-term rates have already started to drift upward since the beginning of 2005, suggesting that markets are heavily discounting chances of rate cuts in the near future.

Longer-Term Issues

According to economic theories that emphasize the role of expectations, the future strongly influences the present. Two categories of issues for Korea will likely command much attention down the road. Although these are somewhat subjective choices, a number of economists seem to be able to sleep only fitfully on account of them.

How can Korea create enough surpluses to meet growing societal needs?

Two trends apparently heading in opposite directions raise the above question. In terms of availability of material resources, many see the deceleration in the growth of Korea's economy since the 1997 financial crisis as an irreversible trend. Some think such a deceleration is not necessarily bad. They argue that past growth had relied mainly on investment and labor, which led to the spectacular debacle in 1997. Korea is therefore unlikely to repeat the same mistake, especially because Korea's labor force will be much smaller owing to the country's demographic trend of a lower birth rate. These people also argue that very rapid growth is not necessarily good, and they cite the connection to Korea's autocratic governments in bygone years.

At the same time, however, a number of new areas demand urgent government attention. Many people are beginning to realize, for example, that Korea lacks an adequate safety net for various disfranchised members of society. It should not surprise anyone to see vote-conscious politicians getting busy, trying to remedy the situation by widening the safety net. Babyboomers will reach retirement age in about 10 years' time, and this will put a tremendous burden on Korea's new national pension system. Also, like their cohorts in Japan and France, Korea's farmers, whose ranks are rapidly dwindling, have found the opening up of agriculture markets very injurious. To placate Korean farmers in 2003 when Korea signed a free trade agreement with Chile, which buys many Korean-manufactured products, the government promised farmers large sums for many years to come.

Many vocal nongovernmental organizations are also finding issues that they feel can no longer be neglected. The poster issue is the environment, and many people find appalling the past disregard of the environment at the expense of expansion. They and their groups are putting brakes on key SOC projects. Protests by a few environmentalists about possible damage to salamanders near a planned railroad track have delayed the completion of the rapid rail connection between Seoul and the southern port city of Busan.

Such big-picture issues call for big ideas. The late Mancur Olson, author of *Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities,* offered some ideas that have been aptly revived in recent writings that address the obvious disparity since 1990 in growth trends between English-speaking economies (fast growers) and non-English-speaking economies (foot draggers). Martin Wolf, for example, wrote in the *Financial Times* of 13 January 2005 that, as a nation gets richer, it is typical to see an emergence of "distributional coalitions"—interest groups seeking their own narrow advantage—that can ossify economies:

> Defeat in the second world war had destroyed many of these coalitions in Japan, Germany, France and Italy, thus enabling the great catch-up era. All good things come to an end. The better things are, the more complacency sets in. Distributional coalitions re-emerged with great force because economic success made higher taxes and regulations seem next to costless. In the 1960s and 1970s, public spending, welfare benefits and regulations jumped in the three continental countries. Over time, these sapped economic flexibility and slowed innovation and adaptability. This then showed itself in declining productivity growth and rising unemployment.

If this were to be a key reason for the recent woes of the Korean economy, ramifications would be both serious and unpleasant. Most of all, Korea is much poorer and less able than Japan and Germany to withstand ill effects of such an ossification, which might make clamoring for shares of the economic pie by various members of the "distributional coalition" all the more vicious and destructive. The recent increase in discussions about improving equity of income distribution may be a sign of the maturity of Korean society. It does not appear purely coincidental, however, that such a trend has emerged since the 1997 financial crisis and the Korean economy's ability to create jobs has waned.

How can these surpluses be created in Korea when trends in employment are not particularly favorable?

A telling indicator of the employment situation in Korea is the fact that its ratio of wage earners (or paid employees) to total population is well below the levels of other OECD countries. A large segment of Korea's population is self-employed or engaged in noneconomic activities (***Table 1***). The ratio of wage earners in Korea is 17 percentage points lower than in Japan, despite Japan being mired in an economic slump for the past 15 years and facing a rapidly aging population.

***Table 1*. Paid Employees in Korea and Selected Countries, 1995, 2000, 2003, percentage**

	Korea	Japan	U.S.	Germany	Australia
1995	40.1	56.5	66.3	57.7	56.8
2000	38.8	57.4	67.0	58.4	59.2
2003	41.0	58.0	67.4	57.2	60.0

Source: *OECD Factbook 2005* (Paris: Organization for Economic Cooperation and Development, 2005).
Note: Table shows the proportions of paid (non-self-employed) workers to the total number in the working-age populations (15–64 or 16–64). Proportions were constructed with information on ratios of self-employed out of total employment in each country (see *OECD Factbook 2005,* page 105, http://ariel.sourceoecd.org/factbookpdfs/05-01-04.pdf; and page 95, http://ariel.sourceoecd.org/factbookpdfs/05-01-01.pdf).

Almost by definition, private and public burdens imposed on wage earners tend to be heavier in an economy with fewer employees relative to population because more households may have only one income earner. In such a circumstance, household income will plunge dramatically if the head of the household becomes unemployed. Consequently, a typical wage earner will push harder for improvement in compensation as well as in job security. If the number of workers in this situation were high, there would be less coherence between wages and productivity, and more fierce resistance to employment adjustment. As a result, the labor market would become more rigid.

The deterioration of employment quality in Korea also has emerged as a serious concern. The share of part-time workers, mostly involuntary, is also expanding rapidly. Another worrisome trend is the sharp decline in the number of large-size workplaces, including those in the manufacturing and non-manufacturing sectors. The share of workplaces with 500 or more employees in the total employment pool decreased from 17.2 percent in 1993 to 8.7 percent in 2002, while the share of workplaces with fewer than 20 employees expanded from 48.7 percent to 55.9 percent.

The emergence of these trends is closely linked to the steady expansion of small-size companies in the service sector and many mom-and-pop stores. In general, small-size workplaces are inferior to large-size workplaces in terms of wages and working conditions. Some may dismiss these developments as a natural adjustment process of the industrial structure;

however, most changes to the industrial structure are driven by changes in the underlying economic factors. For example, a rapid increase in wages, unmatched by a commensurate rise in productivity, is a common cause of a loss in competitiveness and eventual failure for a particular line of business. Labor costs, usually the largest share of operating expenses, represent the most critical factor in determining a company's overall competitiveness. Also, the more workers on a firm's payroll, the more serious labor-management problems tend to be in Korea, which partly explains the decrease in the number of large-size workplaces.

Figure 2 shows the ratio between the number of total employed and the number of people over the age of 15 (in other words, the size of the working-age population in Korea) between 1995 and late 2004. During that period, the number of those employed rose by 2.25 million, to 20.2 million, whereas the working-age population grew by about 4 million, to 37.3 million. Hence, the ratio has shifted down distinctly since 1998. Such sluggishness in the aggregate employment growth, not really captured by an official unemployment rate hovering in the 3 percent range, on top of the deterioration of employment quality seen earlier, presents a source of concern.

A firmer domestic demand base is greatly needed if Korea is to moderate cyclical shocks originating from external demands that have largely determined business cycles in Korea since the mid-1990s. Such a trend will not be possible without a solid employment base undergirding it. Making visible and enduring progress in this area by invigorating private sector employers is a crucial task of the government as well as businesses in order to ultimately improve the affordability of amenities of advanced economies that many Korean citizens are impatiently demanding.

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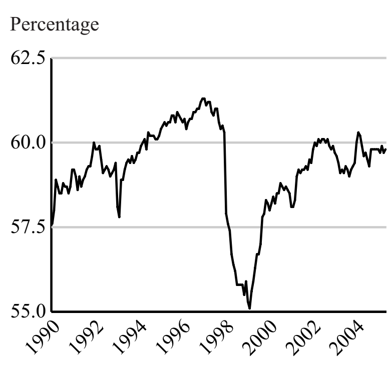
Figure 2: **Ratio of Employed People to the Total Working-Age Population in Korea, 1990–2004**



Source: Korea National Statistical Office, www.nso.go.kr/eng/.

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