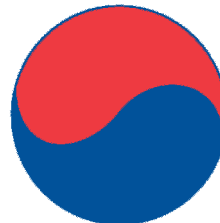


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# OVERVIEW AND MACROECONOMIC ISSUES

## KOREA'S ECONOMIC PROSPECTS AND CHALLENGES

By Jerald Schiff

### Introduction

Although Korea has seen its economic growth rates come down from the stratospheric heights of previous decades, it remains, by any advanced-country yardstick, a successful economic performer. Korea's real GDP rose by 5 percent in 2006, with inflation well-contained at about 2 percent for the year. Only a mild slowdown is expected this year, in line with a decline in growth in its key trading partners, the United States, the European Union, and Japan. Moreover, although unanticipated shocks—such as a more rapid than anticipated cooling of the U.S. economy—could have important effects on the Korean economy, fundamental structural changes since the Asian crisis a decade ago leave Korea well-placed to weather such developments successfully.

Beyond the next few years, however, Korea's challenges appear to be considerably more daunting. A rapidly aging population will require large public outlays for pensions and health care. In addition, the expected decline in the labor force, combined with the ongoing shift of workers from manufacturing to services, where productivity is much lower, will make it difficult for Korea to maintain growth rates in the current range. And growing inequality is challenging policymakers to find ways to ensure that economic growth benefits all. Although these challenges will all require significant changes, Korea's economic history clearly gives confidence that they will all be met successfully.

Let's turn now to examine Korea's economic prospects for 2007. Following that, we will examine in more detail those longer-term challenges noted above and discuss briefly how economic policy can help ensure these challenges are met successfully.

### A Soft Landing for Korea?

From 2005 until early 2006, Korea enjoyed a period of rapid growth—on the order of 6 percent on an annual basis—combined with low inflation.<sup>1</sup> Exports were strong, reflecting in part the global electronics-sector upswing; nearly 40 percent of Korean exports consists of electronics. Korea has also been benefiting from the boom in neighboring China, which now stands as Korea's most important export market. On the domestic front, consumption was recovering from the credit card crisis of 2003, which had severely damaged the balance sheets of Korean households. By early 2005, the process of adjustment was sufficiently advanced for banks to begin lending to households again and for consumption to rise, indeed to increase at a more rapid rate than personal incomes. The favorable economic situation attracted large capital inflows, strengthening the *won* and helping to keep consumer price inflation below the Bank of Korea's target range of 2.5 to 3.5 percent per year.<sup>2</sup>

More recently, the Korean economy has slowed, as had been widely anticipated. But the slowdown has been moderate, with growth for 2006 standing at 5 percent (*Table 1*). Exports have continued to per-

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1. This section is based on a more detailed description and analysis of economic developments through mid-2006 in "Republic of Korea: 2006 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Korea" (Washington, D.C.: International Monetary Fund, 2006), <http://www.imf.org/external/pubs/ft/scr/2006/cr06380.pdf>.

2. Until the end of 2006, the Bank of Korea targeted core inflation in a range of 2.5 to 3.5 percent. Beginning 2007, the target has been switched to headline inflation, with the same numerical range of 2.5 to 3.5 percent.

form well, with Korean information technology (IT) companies prospering and shipbuilders experiencing a boom as global ship replacement cycles coincide with large purchases by cash-rich oil exporters. But Korean exporters are increasingly facing headwinds, as U.S. growth has slowed and as an appreciated *won* has made continued gains in productivity paramount for Korean manufacturers. Indeed, export growth decelerated in the last few months of 2006, although it is too early to say whether such a trend will continue. On the domestic front, consumption has also begun to slow to levels more consistent with income gains; and, while fixed investment remains quite robust, investment in construction has been held back in part by an unsettled policy environment.

**Table 1: Selected Economic Indicators for Republic of Korea, 2004–07**

Indicators	2004	2005	2006	2007 (projected)
Real GDP growth	4.7	4.2	5.0	4.4
CPI inflation (average)	3.6	2.8	2.2	2.5
Growth in export of goods	30.6	12.1	14.8	9.8
Current account (percentage of GDP)	4.1	1.9	0.7	0.3

Sources: International Monetary Fund (IMF), various years; IMF, *World Economic Outlook* database, various years; IMF staff estimates.

Note: Data show year-on-year percentage change, unless otherwise indicated.

So, what does 2007 hold in store for Korea? In broad terms, we expect to see a continuation of recent trends, with quarter-over-quarter growth remaining approximately at levels reached during 2006. This would imply growth for the year as a whole of about 4.5 percent, broadly in line with Korea's trend, or potential, growth. Export growth should remain solid, mainly owing to the extremely strong market positions held by a number of large IT and shipbuilding companies, but is expected to slow from nearly 15 percent in 2006 to about 10 percent this year because of the less favorable global environment. Private consumption will moderate, but a fairly firm labor market—with unemployment steady at under 3.5 percent—and lower oil prices should allow growth of about 3.5 percent in

2007. Investment in machinery and equipment is anticipated to gradually moderate during 2007, in line with slowing exports, while the incipient recovery in construction should continue, although there is considerable uncertainty here. Aided by lower oil prices, inflation is projected to remain toward the low end of the central bank's inflation target of 2.5–3.5 percent. Overall then, if not all one would hope for, a reasonably good year. Indeed, substantially better results will likely await greater progress on a range of structural reforms, which have the potential to raise Korea's growth potential, as discussed below.

### **The Global Environment: What Could Go Wrong?**

A number of external risks could, if they materialize, lead to a more rapid slowdown in Korea and the global economy. Perhaps most important in this regard is the possibility that the United States, rather than experiencing a gradual cooling as expected, instead finds itself in something more like a true recession. One way this could occur would be if the U.S. housing market declines more sharply than anticipated or if this decline spreads more broadly to other sectors of the U.S. economy. Given the size of the U.S. economy, any serious slowdown there would have global effects. And because Korea is an open economy, heavily dependent on exports for growth, the impact could be significant. Although there has been a good deal of discussion of late about the extent to which Asia has delinked from the United States and so may be able to sustain strong growth even with a sharp U.S. slowdown, this should not be overemphasized. In this regard, it is interesting to note that the correlation between U.S. domestic demand growth and Korean export growth has actually increased in recent years, from 0.36 during the period 1971–95 to 0.78 during 2000–06.

So, how big an impact might a sharp U.S. slowdown have on Korea? A broad rule of thumb based in part on previous U.S. slowdowns suggests that a 1 percentage point decline in U.S. growth—say from 2.5 percent to 1.5 percent—could lower 2007 growth in Asia by roughly 0.4 percentage points. But the impact would depend on the nature of the slowdown and could vary significantly across countries. For example, would a slowdown lead to U.S. consumers and corporations' cutting back sharply on electronics

imports? If so, Korea could be particularly affected. In 2001, when a U.S. slowdown coincided with the bursting of the IT bubble, Asian growth was dramatically affected, declining on average by some 5 percentage points. One factor working in Korea's favor is that it is well-placed to offset any cyclical slowdown with supportive macroeconomic policies. With the fiscal stance cautious and inflation low, the possibility exists of loosening fiscal or monetary policy if necessary.

A sharp U.S. slowdown—or other currently unanticipated events—could also trigger a shift in investor sentiment and, potentially, a disorderly unwinding of global imbalances, with negative consequences for global financial-market volatility and growth. Global capital markets have for some time been very supportive of growth—equity prices are generally high, spreads for sovereign and corporate debt are tight, and asset and currency market volatility is close to historical lows. The flip side of this benign situation, however, is that these same financial markets could easily become unsettled on negative news.

Finally, new spikes in oil prices could lower Korea's growth and complicate monetary policy. Over the past six months, a sizable decline in oil prices has cushioned the slowing of Korean domestic demand and helped keep inflation well in check. But global oil supplies remain tight, and the possibility of adverse geopolitical developments is always present.

### **Risks at Home**

Beyond these global risks, Korea faces several potential problems on the domestic front. Developments in North Korea always have the potential to do real damage to Korea's economic prospects, to say nothing of the broader possibilities for serious political and humanitarian consequences. In this regard, however, it is noteworthy that the test of a nuclear weapon by North Korea in October 2006 had only a minor temporary impact on Korean financial markets and, seemingly, on the confidence of Korean consumers and businesses. This stands in contrast with reactions to previous (and arguably less serious) episodes—North Korea's withdrawals from the Nuclear Non-Proliferation Treaty and the International Atomic Energy Association—which had sizable impacts on the Korean stock and currency markets for one to three

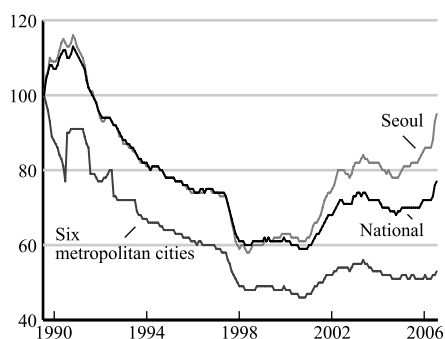
months. This points to the improvements in economic fundamentals and strengthening of the financial sector in Korea over the last decade, which have served to limit greatly Korea's vulnerability to economic shocks.

A second domestic risk relates to the housing market. Considerable attention is being directed to the recent rapid rise in home prices in Korea. On the one hand, arresting these price increases has become perhaps the key economic objective of the current administration. On the other hand, financial supervisors and other economic policymakers are increasingly focused on the potential for a sharp reversal of these price hikes to damage the Korean banking system and, more broadly, macroeconomic performance. To understand better these concerns, it is important to note that mortgages remain quite short in duration in Korea—three-year mortgages with a bullet payment at the end of the period are still typical—while virtually all mortgages have adjustable interest rates. Korean homeowners have relied on the ability to roll over their mortgages at the end of three years, while banks have usually been happy to comply as rising home prices increase the value of their collateral. A sharp turnaround in housing prices could reverse this cycle of events: banks could become less willing to roll over loans, leading households to cut back sharply on other spending or even forfeit their homes. Collateral would, at least in part, protect the financial sector in these circumstances—and banks remain quite well capitalized—but the impact on the macroeconomy could be significant, in particular if banks became less willing to lend in general. The situation becomes all the more troubling when one realizes that Korean households are already quite heavily indebted by international standards, with household debt standing at about 120 percent of disposable income, comparable with U.S. levels.

So, how big a risk is this? One's view on how likely a sharp decline in housing prices—as opposed to a gradual cooling—really is depends, in large part, on what you think is behind the run-up. In particular, does the increase reflect real underlying forces of supply and demand—which are unlikely to reverse dramatically in a short period of time—or is it a reflection of speculation and expectations run amok, aided by abundant liquidity in the financial system? In all likelihood, both real and speculative factors play a

role, and the sad fact is that asset bubbles can really be identified with certainty only after they burst. But a few points are worth emphasizing in this regard that may point to the primacy of real factors. First, although price hikes were considerable in 2006—an estimated 11.6 percent nationwide—real housing prices still remain well below historical highs, and housing prices have not grown much faster than incomes in the postcrisis period (*Figure 1*). Second, the housing price rise is centered in and around Seoul, with some cities experiencing small or even negative price changes in 2006. Such a development is difficult to explain on the basis of speculation alone. But real factors—such as high demand for education services in Seoul—can perhaps explain this difference. And, third, housing prices are also rising rapidly elsewhere in Asia, in part reflecting a long period following the Asian crisis of 1996–97 of stagnant investment in housing.<sup>3</sup>

**Figure 1: Real Housing Prices in South Korea, 1990–2006 (January 1990 = 100)**



Source: CEIC Data Company, Inc.

Note: The six metropolitan cities are Busan, Daegu, Daejeon, Gwangju, Incheon, and Ulsan.

To summarize, then: This year looks set to be one of reasonably good, if not spectacular, growth in Korea, with continued low inflation. As always, a downturn in the global economic environment would of course affect Korea. Several potential domestic risks loom as well. But the Korean economy continues to show resilience to such risks so that, overall, there is reason for cautious optimism.

Nevertheless, there appears to be widespread dissatisfaction among the Korean public with growth rates in the range experienced during the past several years. This is perhaps understandable in light of Korea's rather remarkable modern economic history. However, this longer-term slowdown is not cyclical but, rather, reflective of deeper structural issues as well as Korea's transformation into an advanced industrial economy. Indeed, as noted above, Korea in the past few years has been growing at or near its current potential. The focus then should be on raising Korea's growth potential or, at a minimum, limiting any future decline. We turn now to examine these longer-term structural issues.

### Korea's Long-Term Challenges

Korea's demographics—a rapidly aging population and one of the lowest birth rates in the world—will almost certainly have a dramatic impact on the country over the coming 50 or so years. First, an aging population is expected to generate enormous expenditure pressures on the Korean government. While such long-run projections are inherently difficult to make, the government itself has estimated that by 2055 additional spending caused by an aging population—mainly pensions and health care—could, in the absence of any policy changes, reach as high as 15 percent of GDP. Such spending pressures are quite dramatic, dwarfing even those currently faced by a number of aging industrial countries in Europe. It is important to emphasize that they come on top of potentially important spending pressures from other sources, including the desire of the Korean government to strengthen its social safety net in a number of dimensions and—here, the proverbial elephant in the room—the possibility of unpredictably large expenditures in the event of reunification with North Korea.

How can such large spending pressures be addressed? Any strategy would likely need to have a number of elements. First, pension and health care reform to limit the rise in the additional burden would be critical. Indeed, the government has made efforts to introduce pension reform—aimed at raising contributions and lowering benefit levels—but, as in virtually every coun-

3. See Thomas F. Cargill and Federico Guerrero, "Bank of Korea Policy and the Asset Bubble Problem," in this volume.

try where such reforms are attempted, achieving consensus will likely take time. Second, scope for lowering other (non-age-related) spending as a share of GDP needs to be explored. This may not be a simple matter for Korea, where government spending is already the lowest (as a percentage of GDP) among the countries that are members of the Organization for Economic Cooperation and Development (OECD), but even slowing the rate of growth in such spending can have a large payoff over the longer term. Third, revenues will likely need to rise as a share of GDP. There appears to be scope for such a rise—Korea is next to last in the OECD (ahead of only Mexico) in the government revenue-to-GDP ratio, at least partly owing to problems of tax compliance. But, to the extent possible, revenues should be generated by broadening the tax base—the personal income tax would appear to be a prime candidate here, judging by its very low tax yield—and by improving tax administration. Tax rate hikes are considerably less attractive, as higher rates can lower growth by distorting decisions to work, save, and invest and can also encourage both legal tax avoidance and illegal tax evasion. Finally, it is likely that, whatever gains can be made in limiting spending increases and raising additional revenues, Korea will see its debt-to-GDP ratio rise somewhat over the medium term. Of course, raising debt brings with it its own risks. But at least Korea is well-placed to bear some modest increase—its public debt, at about 30 percent of GDP, remains on the low side by international standards, while its very large stock of international reserves serves as an important shock absorber, limiting potential vulnerabilities.

These long-term fiscal pressures are well understood by the Korean authorities. However, it appears that public debate is only now beginning regarding the difficult trade-offs that will inevitably be faced. It is tempting to think, as spending pressures will rise only gradually and reach their peak only 50 years from now, that there is plenty of time to worry about this later. Tempting, but wrong. The longer action takes, the sharper will be the needed rise in tax rates and cuts in spending and the heavier the burden on the Korean economy. In contrast, undertaking more mod-

est but timely reforms today can generate large gains over the medium term.

Population aging will contribute to another critical challenge facing Korea, that of raising potential growth. In the simplest terms, a country's ability to grow will depend on changes in the size of its labor force and its capital stock as well as its ability to continually raise productivity. Korea's demographics again come in here, as the country's labor force is expected to peak at about 25 million in roughly 15 years and then steadily decline, falling below 20 million by 2050. Of course, such projections rest on a number of assumptions, for example, that birth rates remain low and that participation rates in the labor force remain at current levels. The latter in particular could be overturned if women raised their participation toward more typical industrial-country levels. But the basic fact remains: Korea is likely to see a smaller labor force in the coming decades.

Let's turn now to the second growth determinant, the capital stock. Investment in Korea dropped sharply in the wake of the Asian crisis of 1996–97, from about 37 percent of GDP to below 30 percent of GDP. Although this should perhaps not be a surprise, what is more notable is that investment levels have not recovered over the past decade. This pattern has been repeated throughout emerging Asia (with the important exception of China)—despite the broader recovery of Asian economies postcrisis—and a lively debate among academics and policymakers has yet to reach a definitive view of the reasons behind these stagnant investment levels. One likely factor is that precrisis investment levels were unsustainably high. However, this is unlikely to be the full explanation. Among other factors emphasized for the region as a whole are a riskier global investment environment, structural weaknesses in corporate and financial sectors, and sluggish nontradable sectors, including services.<sup>4</sup>

Finally, we come to the issue of productivity growth. If capital and labor stock growth are slowing, then growth can be maintained only by making more effi-

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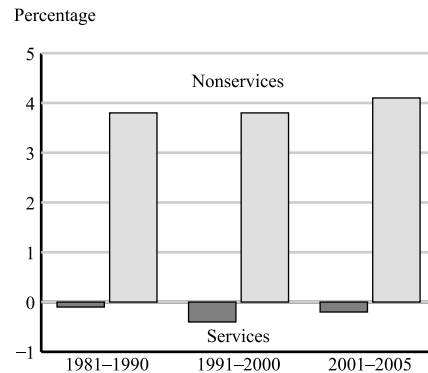
4. A number of studies have examined the roots of Asia's investment slump, including the IMF, *World Economic Outlook*, September 2005, [www.imf.org/Pubs/FT/weo/2005/02/index.htm](http://www.imf.org/Pubs/FT/weo/2005/02/index.htm).

cient use of these factors, that is, by increasing productivity. In fact, Korea has been extremely successful in doing this, at least in its manufacturing sector. In the period 2001–05, the growth in nonservices productivity in Korea has exceeded 3 percent per year, down slightly from 1991–2000 but still an impressive figure by any measure. Large Korean companies have become global leaders in their fields—IT and ship-building are two key examples—and this has reflected not simply efficient production but a continued search for innovation in what and how they produce.

Outside of these large manufacturers, however, the story is quite different: in the services sector, productivity growth has hovered at close to zero since the early 1990s (*Figure 2*). In fact, the gap in Korea between productivity growth in manufacturing and in services is the largest in the OECD. This is a particular concern as the services sector is becoming increasingly important in Korea—the share of employment in services has doubled from about one-third in 1975 to two-thirds today—a trend that is expected to continue over the medium term. Moreover, small- and medium-size enterprises (SMEs)—which account for fully half of Korean manufacturing output and 87 percent of total employment—are finding it increasingly difficult to compete in the global marketplace. Indeed, much of the stagnation of investment in Korea reflects a sharp cutback by SMEs—during 2003–05, facilities investment by SMEs actually declined by 18 percent annually.<sup>5</sup>

So, what does all this mean for Korea’s growth potential over time? Of course, as one attempts to project out farther into the future, uncertainties multiply. But IMF staff have projected that, in the absence of reforms to address those issues noted above, annual potential growth will decline from about 4.5 percent today to just over 2 percent by about 2030.<sup>6</sup>

**Figure 2: Total Factor Productivity Growth in Korea, 1981–2005 (average annual growth rate, percentage)**



Source: International Monetary Fund staff estimates.

What can be done to arrest this decline in growth potential? A broad array of policy changes should be considered, but it seems clear that any successful effort to maintain growth at or near its current levels will need to deal forcefully with the difficult structural problems holding back SMEs and service sector growth.

A key element of this effort will need to be continued financial-market development. While Korea’s financial system has been strengthened and restructured dramatically since the Asian crisis, its capital markets remain less well developed.<sup>7</sup> In fact, financial-sector development is a key element of the Korean government’s own medium-term plan, which envisages Seoul as a regional financial center within the next decade. Financial-sector development will spur the services sector both directly—as financial services themselves become an engine of growth—and via the impact of an effective and innovative financial sector on, for example, the level and efficiency of

5. See section 4, A Strategy for Restructuring the SME Sector in Korea, “Republic of Korea—Selected Issues,” IMF Country Report No. 06/381 (Washington, D.C.: International Monetary Fund, October 2006), 44, [www.imf.org/external/pubs/ft/scr/2006/cr06381.pdf](http://www.imf.org/external/pubs/ft/scr/2006/cr06381.pdf).

6. See section 1, Korea’s Transition to a Knowledge-Based Economy: Prospects and Challenges Ahead, *Ibid.*, 2.

7. For details, see section 2, A Financial Big Bang in Seoul? The Development of the Financial Sector in Korea, *Ibid.*, 19.

investment in the rest of the economy. Efforts will also need to be directed at fostering competition in services via deregulation in sectors such as education and health care and further trade liberalization, facilitating greater market-based access to private finance for small and knowledge-based firms, and encouraging the restructuring of inefficient or unproductive firms through less burdensome bankruptcy procedures.

A final challenge facing Korea—and the Asia regions more generally—is growing economic inequality and polarization.<sup>8</sup> After falling for much of the 1980s and rising only modestly in the early 1990s, income inequality in Korea surged during the Asian crisis as lower-wage employees were hard hit by corporate layoffs. The impressive postcrisis recovery has not slowed the rise in inequality. In fact, the rise in inequality since 1997 is not matched by any other industrial country. This rise in inequality matters. First of all, the success of any economic system should be judged not simply in terms of growth and inflation but also by how broadly the benefits of that growth are shared. Perhaps more subtly, rising inequality can make it more difficult for societies to enact efficient economic policies, and governments can become increasingly bogged down in purely redistributive issues, to the detriment of all.

The reasons behind the rise in inequality in Korea, and worldwide, are not fully understood, but technological change and pressures from international trade are likely playing important roles. Increased competition from China and a high degree of computer and IT penetration in Korea have limited demand for less-skilled workers and raised wage dispersion.

Solutions to growing inequality will likely not be easy to find. But in Korea at least, one key is to address the growing dualism in the labor market—growing inequality has been exacerbated by the fact that a rising share of workers does not have the status of permanent salaried employees, and these workers lack both

the job security and benefits of so-called regular workers. Strict policies on dismissals and other employment protections for regular workers have had the perverse impact of causing firms to hire larger numbers of nonregular workers. Easing costs to companies of regular employment would help reverse this trend.

## CONCLUSION

Fifty years ago, when Korea joined the International Monetary Fund, it was the poorest member of the institution, with an annual per capita income below \$400. Following a strategy of integration with the global economy, it has made remarkable gains over the past five decades and now stands as the 11th-largest economy in the world. Days of double-digit growth may well be in the past, and a number of difficult long-term challenges loom. But Korea's economic history can only leave one with confidence that it will meet these challenges successfully and remain a powerful force in the global economy.

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8. See section 5, A Family Divided, Revisited: Income Inequality and Social Polarization in Korea, *Ibid.*, 67; also see “Rising Inequality and Polarization in Asia,” *Regional Economic Outlook: Asia and Pacific* (Washington, D.C.: International Monetary Fund, September 2006), chapter 6, [www.imf.org/external/pubs/ft/reo/2006/ENG/02/areo0906.pdf](http://www.imf.org/external/pubs/ft/reo/2006/ENG/02/areo0906.pdf).



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