South Korea

Small reforms

- Growth is likely to slow further in 2016.
- The impetus provided by the recently announced stimulus package will probably not be enough to kick-start the economy for the long term.
- More fundamentally, the reforms undertaken over the past three years in an attempt to rebalance the growth model have not worked.
- The country remains too dependent on its export sector and therefore vulnerable to fluctuations in global demand, whilst the level of household debt creates constraints for monetary policy.
- South Korea nevertheless has substantial room for manoeuvre on the fiscal front, but does not appear prepared to use it.

Support from the authorities

Economic growth in South Korea is running out of steam. Having averaged nearly 5% between 2000 and 2010, real GDP growth has slowed, with an average of just 3% between 2011 and 2014, followed by 2.6% in 2015. This slowdown is likely to continue in 2016. Over the first five months of the year, exports (55% of GDP) fell by 12% relative to 2015 and, despite stimulus measures, growth in internal demand remains weak. Real GDP growth is unlikely to be above 2.5% in 2016.

The government's own view is barely more optimistic than this: its new forecasts for growth and inflation have been cut to 2.8% and 1.1% respectively for 2016, from 3.1% and 1.5% respectively. As a result, a new stimulus package has been announced: the Central Bank has cut its policy rate by 25 basis points to 1.25%, and a fiscal support programme worth KRW10 trillion (0.6% of GDP) has also been introduced. The impetus this will give looks inadequate: as in 2015 the measures announced will have only a marginal effect on 2016 growth.

...but still not enough

The room for manoeuvre in macroeconomic policy is limited or not fully exploited. Monetary policy is constrained by the high level of household debt, which rose from 130% of disposable income in 2010 to 143% in 2015 (85% of GDP). Further cuts in interest rates would act against the government's target of reducing households' debt. The macro-prudential measures introduced since 2008 have helped improve the structure of debt[1], but Korean households remain exposed to the risk of a real estate crisis.

On the fiscal front, the additional spending announced will just enable the 2015 spending level to be maintained. It will barely offset

Economic growth is slowing

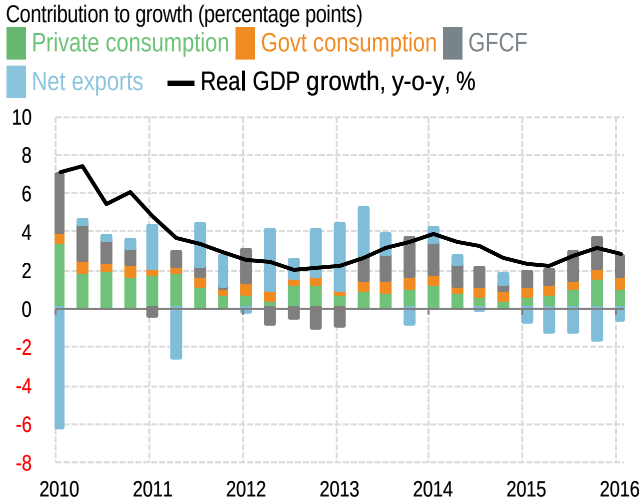

Figure 1 Source: KOSTAT

the recessive effects of the restructuring plan for companies in the shipbuilding sector. The sector's main companies (accounting for nearly 7% of GDP and 10% of exports) have been weakened by competition from China and the slowdown in global trade. In return for the state support they enjoy and the rescheduling of their debt, they must reduce production capacity by 20% and cut 30% of jobs by 2018 (equivalent to 60,000 jobs, or 0.25% of the active population).

The government nevertheless has significant latitude to support economic activity, thanks to the rigourous management of economic policy since the early 2000s. Including the supplementary stimulus package, the government deficit will remain low in 2016, at 2.3% of GDP (excluding the social security fund) and government debt will remain below 40% of GDP. The government has also strengthened its credibility by restructuring contingent debt (covering state-owned companies and local authorities). This had reached 38.8% of GDP by the end of 2012, but was cut to 30% of GDP by 2015.

Over and above any political analysis (the government lost ground in the mid-term elections in April), the small scale of the plan reflects mainly a strong cultural attachment to a balanced budget. The aim is to anticipate future pressures on spending over the medium to long term, linked to an ageing population and the potential cost of economic cooperation with North Korea.

A negative outcome

Above all, successive waves of measures have provided only temporary support to growth and underscore the failure of the "Three Year Plan for Economic Innovation", introduced since the government came to power in 2014. Based around four main pillars – education, the public and financial sectors and the labour market – the three-year plan aimed to increase potential growth by prioritising

[1] Notably, the share of fixed-rate loans and the average maturity of loans have increased considerably; loans to low-income households and those taken out with non-banking institutions have been very tightly regulated.

internal demand as an engine of growth, particularly by supporting SMEs and the services sector and by reducing household debt. Over the longer term, the plan aimed to anticipate the economic and financial effects of an ageing population[2].

Two years after its introduction, we are still waiting for the effects to be seen and the economy continues to suffer from two-speed growth. On the one side major industrial groups, specialising in upscale technologies destined for export markets, employ a very small share of the population. On the other, small and medium-sized companies continue to suffer from a lack of competitiveness and efficiency.

Although considered essential, the reform of the labour market is currently blocked. The economy is not creating many jobs and the unemployment rate is rising: it reached 3.8% in May, from 3% in early 2014. The labour market remains split between temporary and permanent workers (the latter being paid twice as much as the former), which hits young people particularly hard. In May the unemployment rate for those aged between 15 and 24 was 11%. Government initiatives to increase the participation rate – improving conditions for temporary workers, encouraging companies to take on permanent staff, whilst increasing the flexibility of the labour market – have not worked so far.

The export sector is not infallible

Lastly, the government's strategy (one-off and limited support for demand in the short term, rather than any priority given to structural reform) has proved counter-productive. The economy is still dependent on the export sector, and thus on trends in global demand. South Korea is more highly integrated than the ASEAN nations, both in global value chains and in the regional economy. Exports to Asia account for 50% of the total, with China alone taking 26%.

Due to the high level of exposure to the slowdown in China in the short term, the country thus looks more vulnerable than other regional economies to the structural slowdown in global trade and the decline of the gains from the extension of production chains.

Public deficit is moderate

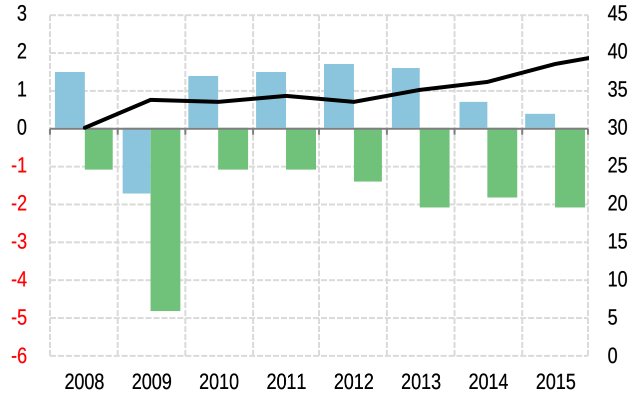

Figure 2 Source: Ministry of Finance

In addition, competition from China could rapidly become a threat to the Korean export sector. For the time being, Chinese companies continue to focus on lower parts of the price range than their Korean counterparts when it comes to semiconductors or cars. But over the past ten years, Chinese competition in third party markets has rapidly expanded to take in intermediate goods and equipment. South Korea now faces competition in its main driving sectors: shipbuilding, electronics and steel making. Over the medium term, the intensification of competition will also play out on a regional level. South Korea would then be unable to allow itself the luxury of not reforming its export sector.

[2]Currently one of the youngest OECD members, the Korean population is set to be one of the oldest by 2050. According to the OECD, the active population will peak in 2016 and by 2050 will have shrunk by a quarter. This will necessarily require a deep-seated change in a model which is currently typified by low levels of hourly productivity and considerable incentives to keep women and those aged over 50 out of the workforce.