Republic of Korea

Despite strong consumption and net exports, growth slowed in 2018. Contracting investment and moderating export growth, though countered by significant fiscal stimulus to sustain domestic demand and consumption, will pare GDP growth a bit further in 2019 and 2020. Inflation will remain tame, and the current account surplus will shrink slightly in both years but remain sizable. Invigorating youth entrepreneurship can address youth employment and spur broader economic dynamism.

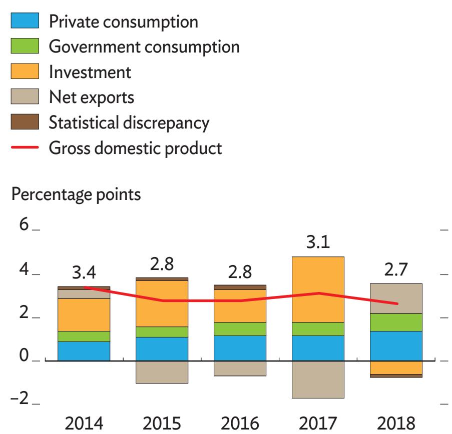
Economic performance

GDP grew by 2.7% in 2018, down from 3.1% a year earlier and the slowest expansion in the past 6 years. Consumption and net exports each contributed 1.4 percentage points to GDP growth (Figure 3.12.1). Expenditure grew by 5.6%, propping up government consumption and providing the biggest impetus to growth. Private consumption rose by 2.8% as a 16.4% hike in the minimum wage outweighed the impact of a 3.8% increase in the unemployment rate as job creation plunged from 316,000 in 2017 to 97,000 last year.

Export growth in real terms doubled from 1.9% in 2017 to 4.0%, backed by strong sales of semiconductors, information technology products, and petrochemicals. Meanwhile, real growth in imports slowed from 7.0% in 2017 to 1.5% as demand softened for manufacturing inputs and as oil prices fell. Investment slumped, subtracting 0.1 percentage points from growth as the uncertain trade environment weighed on firms' investment plans and the government took measures to rein in speculative property development. Machinery investment plunged from 14.6% growth in 2017 to 1.7%, and construction investment shrank by 4.0% as capital gains taxes on multiple homes and property taxes were raised, and as plans were announced to establish anti-speculation zones in Seoul.

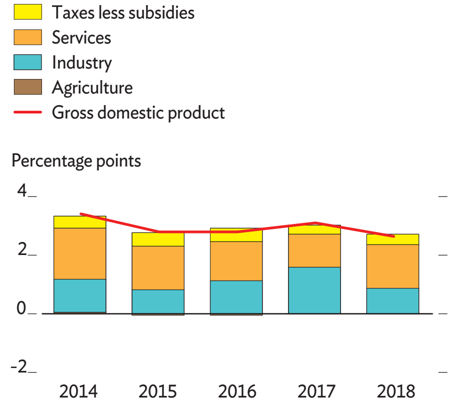
On the supply side, services drove economic expansion as the sector growth rate accelerated from 2.2% in 2017 to 2.9% and contributed 1.7 percentage points to GDP growth in 2018 (Figure 3.12.2). Growth in industrial output slowed sharply from 4.6% in 2017 to 2.5% as demand softened globally and locally, industries outside of semiconductors such as shipping restructured, input costs rose, and construction slowed.

3.12.1 Demand-side contributions to growth



Source: Bank of Korea, Economics Statistics System. http://ecos.bok.or.kr (accessed 5 February 2019).

3.12.2 Supply-side contributions to growth



Source: Bank of Korea, Economics Statistics System. http://ecos.bok.or.kr (accessed 5 February 2019).

This chapter was written by Cindy Castillejos-Petalcorin and Donghyun Park of the Economic Research and Regional Cooperation Department, ADB, Manila.

The contribution of industry to growth fell to 1.0 percentage point. Agriculture recovered to 1.4% growth with favorable weather and higher livestock production.

Inflation was subdued by weak domestic demand and a dismal job market. Reflectingr slower economic activity, consumer price inflation decelerated from 1.9% in 2017 to 1.5% last year, falling further below the official target of 2.0% set by the Bank of Korea, the central bank (Figure 3.12.3). Inflation climbed to 2.0% year on year in September, mainly on higher food prices, and remained stable in the following 2 months, but decelerated again to 1.3% in December as food prices stabilized and housing prices retreated when policies to cool an overheating property market came into effect. Core inflation, which excludes food and energy prices, remained stable at 1.2%.

The central bank maintained an accommodative monetary stance in 2018, motivated by tepid inflation and weakening domestic demand. However, it did raise its benchmark interest rate once, by 25 basis points to 1.75% on 30 November 2018, in response to an increase in the US federal funds rate. Broad money (M2) growth accelerated from 5.1% in 2017 to 6.7% even as household credit expansion slowed with the cooling of the property market (Figure 3.12.4).

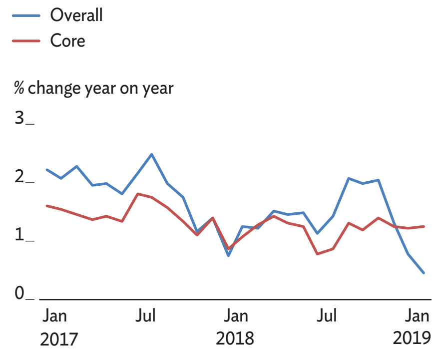
Fiscal policy also remained largely accommodative in 2018. A $3.6 billion supplementary budget was introduced that boosted business subsidies and aimed to reduce youth unemployment. Budgetary revenue decreased, however, as a tax on car purchases was lowered from 5.0% to 3.5% and as fuel taxes were cut by 15% in November. The budget and the supplementary budget together recorded a deficit equal to 0.1% of GDP, compared with a deficit of 1.1% in 2017, and sovereign debt rose from the equivalent of 38.2% of GDP in 2017 to 38.6%.

Following a 20-year trend, the current account registered a surplus in 2018, but the surplus fell to 4.6% of GDP from 4.9% the year before as merchandise exports grew less strongly than merchandise imports. Inbound foreign direct investment increased by 14.2% to a record high of $38.9 billion in 2018, and the surplus in the overall balance of payments boosted official foreign reserves to $404.6 billion at the end of the year. The won appreciated by 2.6% on average against the US dollar in nominal terms and by 1.4% in real effective terms (against a trade-weighted basket of currencies and taking inflation into account).

Economic prospects

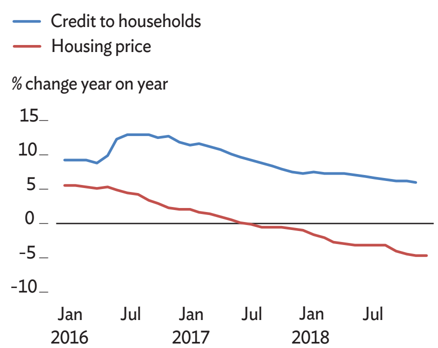
Growth will slow to 2.5% in 2019 and 2020 in line with lower export growth (Figure 3.12.5). Waning confidence is indicated by declines in the Nikkei purchasing managers' index for 4 consecutive months to 47.2 in February 2019 (Figure 3.12.6).

3.12.3 Monthly inflation



Source: CEIC Data Company (accessed 14 February 2019).

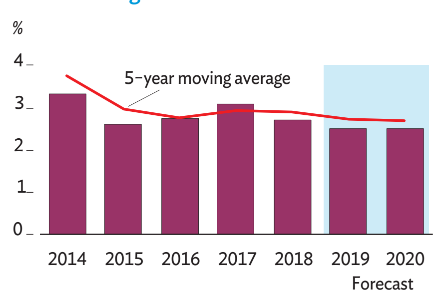
3.12.4 Credit to households and household price



Note: Housing price is the deposit for a 2-year lease on an apartment under the *jeonse* system.

Source: CEIC Data Company (accessed 14 February 2019).

3.12.5 GDP growth



Source: *Asian Development Outlook* database.

Progress in trade negotiations between the US and the People's Republic of China (PRC) is seen to help stabilize falling consumer and business confidence in the coming months but may not restore export momentum as growth in the PRC continues to moderate and as world trade growth decelerates. Any positive impact from a renegotiated free trade agreement between the US and the Republic of Korea (ROK) is similarly overshadowed by global trends.

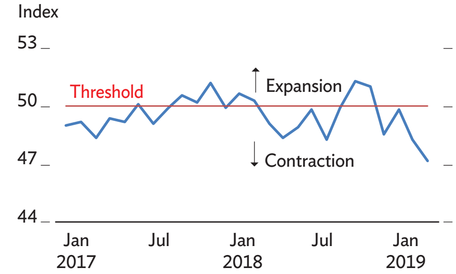
The strong performance by exports in 2018 will not be repeated this year or next because of softening external demand. The global information technology business cycle is heading into a slowdown and could undermine semiconductor exports, the largest ROK export category, accounting for nearly 21% of merchandise exports. Shipments of semiconductors are already falling, as have new export orders from Germany, Japan, and the PRC. Import growth will be lower this year and next, reflecting weaker domestic demand and lower world oil prices. However, the deficit in the service account will narrow on higher tourist arrivals. On balance, the sizeable current account surplus will shrink slightly in the next 2 years to equal 4.1% of GDP in 2019 and 3.9% in 2020.

Growth in private consumption, which provides almost half of GDP, will likely falter under weak employment growth coupled with pessimism regarding economic prospects and rising household debt, which equaled 95% of GDP as of September 2018 (Figure 3.12.7). On the other hand, the government's target to create 150,000 jobs this year will, if achieved, improve household incomes. Public consumption will receive a boost from additional spending in the run-up to general elections in April 2020. Investment will likely remain subdued this year but recover slightly next year. Construction investment will continue to decline, albeit at a slower pace, as the government's efforts to cool the property market constrain growth. Public spending on the 5G telecommunications network and transport infrastructure should spur moderate growth in fixed investment.

Consumer price inflation remained tepid, rising by only 0.5% year on year in February 2019 as transport and communications prices declined. Headline inflation is forecast to edge down to 1.4% in 2019 and 2020, held down by falling international oil prices and softening domestic demand.

Monetary policy will remain broadly accommodative in 2019 and 2020, supporting growth while mitigating risks in the finance and property sectors. As the US Federal Reserve is planning interest rate hikes at a slower pace this year (with only two hikes now expected in 2019, down from three hikes projected earlier), and in the absence of any major shock, there will be no need for the central bank to increase interest rates. That should be welcomed in the ROK in light of the low growth rate forecast and high household debt.

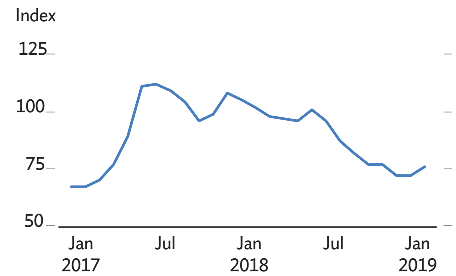
3.12.6 Purchasing managers' index



Note: Nikkei, Markit.

Source: Bloomberg (accessed 14 March 2019).

3.12.7 Consumer confidence



Note: A reading below 100 means that fewer consumers answered positively than negatively.

Source: Bank of Korea, Economics Statistics System. http://ecos.bok.or.kr (accessed 14 February 2019).

3.12.1 Selected economic indicators (%)

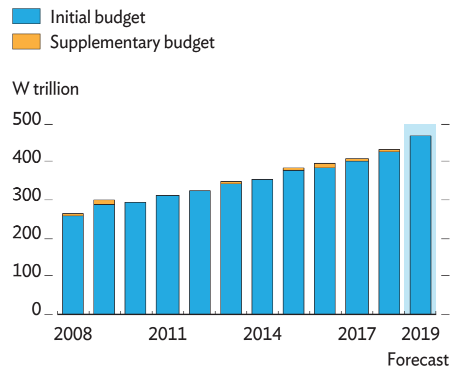
	2019	2020
GDP growth	2.5	2.5
Inflation	1.4	1.4
Current account balance (share of GDP)	4.1	3.9

Source: ADB estimates.

Indeed, given the sluggish job market, and the expected completion of the US monetary tightening cycle, monetary policy is likely to become more accommodative toward the end of 2019.

In a renewed effort to revitalize the economy, the 2019 budget authorizes $420 billion in expenditure—equal to 24.8% of GDP, 11.6% higher than in the 2018 budget and the biggest increase since 2009—to fund health, welfare, and education programs and lend support to local governments (Figure 3.12.8). Revenue will expand by 6.3% with corporate and other tax hikes. This will leave budget deficits equal to 1.8% of GDP in 2019 and 2.3% in 2020, nudging up government debt to the equivalent of 40.2% of GDP at the end of next year.

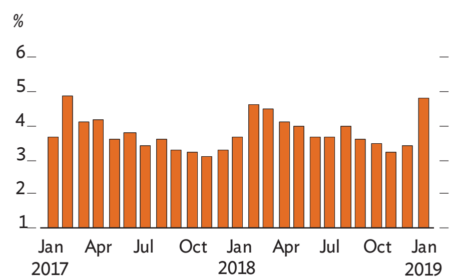
3.12.8 Fiscal spending, 2008–2019



Source: Ministry of Economy and Finance.

Upside risks to the outlook include growth in the global economy and the PRC that exceeds expectations, a successful resolution of the US–PRC trade dispute, and an improving relationship with the Democratic People's Republic of Korea. However, most risks are on the downside. Moderating growth globally—and especially the slowdown in the PRC, the largest trade partner of the ROK—will weigh on growth. Worsening protectionism and the unresolved trade dispute between the PRC and the US will hurt ROK exports, given their place in Asian supply chains. Another risk could be unexpected financial instability in emerging markets in response to monetary tightening in major economies as central banks continue to normalize their policies throughout 2019 and 2020. The principal domestic risks to the outlook are high household debt, which may dampen consumption more than forecast, and the possibility that with the higher minimum wage and a shorter work week, local companies may be unwilling to hire new workers, worsening unemployment from its already high rate in January (Figure 3.12.9).

3.12.9 Unemployment rate



Source: CEIC Data Company (accessed 14 February 2019).

Policy challenge—revitalizing youth entrepreneurship

Weak entrepreneurship is viewed as contributing to the recent slowdown of growth in the ROK. Considered together with a rapidly aging population, this trend raises concern over the prospects for economic growth in the long term. However, demographic change aside, the ROK retains an abundance of youthful energy. As recent research by Edward Lazear shows, youthful countries tend to be entrepreneurial. Fostering youth entrepreneurship is therefore key to catalyzing growth and to reducing youth unemployment, which has emerged in recent years as a major economic and social issue.

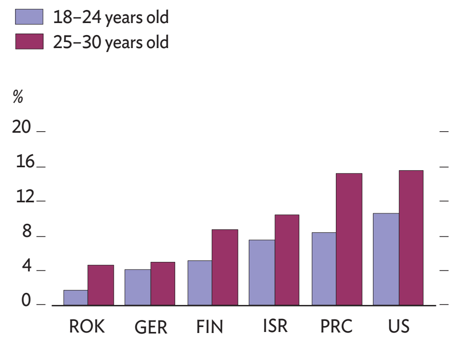
According to surveys by the Korea Institute of Startup & Entrepreneurship Development, entrepreneurship among those 29 years old and under is anemic. While the number of startups in the ROK rose by 6.4% in 2013–2015, youth startups plunged by 40.5%, and their share of the total dropped from 3.0% to 0.9%. The rate at which youth startups survive is significantly lower than the overall rate. Further, according to the Global Entrepreneurship Monitor, youth entrepreneurship in the ROK as a share of all startups nationally substantially lags behind other innovative economies such as Israel, the PRC, and the US (Figure 3.12.10). The Hyundai Research Institute reports that youth entrepreneurship in the ROK tends to be skewed toward wholesale and retail trade, accommodation, and restaurants, where entry barriers such as technological knowhow requirements are low but the potential to create high-quality jobs is limited. More broadly, self-employment in the ROK is trending down as a share of all youth employment.

These surveys reveal that limited access to finance remains the biggest challenge to youth entrepreneurship. The government has established various funds, including policy funds for youth entrepreneurship, to facilitate more access. It has taken other steps to create an environment that encourages private firms and financial institutions to discover, nurture, and invest in or acquire promising startups. These steps facilitated an increase by more than 10% per year in new private venture capital investments from 2011 to 2015, enabling more startups. Going forward, any initiatives and fiscal incentives that the government offers should be directed, to the extent possible, to the more innovative industries and activities, and to those that promise to create the most jobs.

Excessive regulation remains another major impediment to innovative entrepreneurship. In stark contrast with the US and the PRC, which enforce negative lists of activities and technologies closed to startups, the ROK has a more restrictive positive list that specifies only a few business activities and areas open to them. Without a fundamental overhaul of this stifling regulatory framework, innovative entrepreneurship is unlikely to put down roots in the ROK.

Regulations could be relaxed to allow, in particular, the establishment of "sandbox zones," in which youth entrepreneurs are free to develop new products and services and to experiment with fresh ideas, constrained by only minimal regulation. Policy support can be extended for youth entrepreneurs to venture abroad at an early stage of their enterprise development to get a sense of the global marketplace. Meanwhile, the successful transformation of science and technology universities in the US into vibrant cradles of youth entrepreneurship, such as the Martin Trust Center for Entrepreneurship at the Massachusetts Institute of Technology, can provide models for enhancing education in the ROK.

3.12.10 Total early stage entrepreneurial activity, 2016



ISR = Israel, FIN = Finland, GER = Germany, PRC = People's Republic of China, ROK = Republic of Korea, US = United States.

Note: Total entrepreneurial activity is the percentage of members of an age group that own or manage a business that is less than 42 months old.

Source: *Global Entrepreneurship Monitor 2017.*