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KOREA ECONOMIC FOCUS

British Embassy
Seoul

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A wobbly recovery

- **The Bank of Korea revised-down its 2014 GDP growth forecast to 3.5%. Finance Minister announces additional stimulus of KRW 5 trillion in response to weakening economy:**
  - **Industrial output fell by 0.6% qoq in August, and facility investment decreased by 10.6%, the largest drop in 11 years.**
  - **Export growth slowed to 1.7% yoy in September, its lowest level since March.**

External and internal challenges

- **Why is there no noticeable recovery in the Korean economy despite the government's huge stimulus package? Domestic politics (delays in key economic bills), and external risks (weakening Yen and dampened Chinese demand) are mainly to blame.**

Deflation or Stagflation?

- **The government believes the Korean economy is entering a stage of deflation, with inflation hitting a 7-month low of 1.1% September following 1.4% in August.**
- **Some experts, however, are concerned about stagflation, as many key consumer product prices are increasing, including gas and electricity prices, foodstuffs and taxi fares.**

Risk of low growth trap: real wage rise needed

- **The Korean economy has continued to grow for over 20 years, but this growth has become decoupled from real wages which have grown by less than half the rate of headline growth.**

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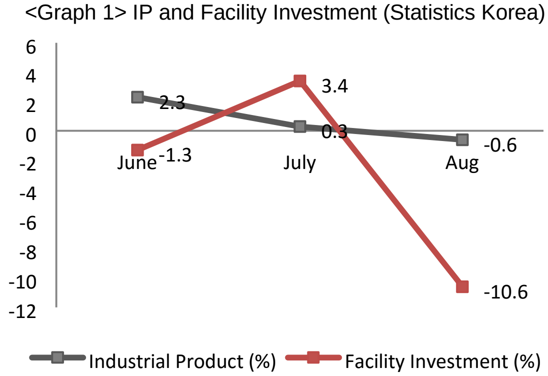
On 8 October Deputy Prime Minister Choi, who is also the Finance Minister, decided to inject another KRW 5 trillion (£3bn) into the slowing economy. This latest stimulus mainly comprises loans and insurance cover to SMEs exporting to Japan, hit by the weakening Japanese Yen. The government had already set aside KRW 26 trillion (£15bn) for 2014 as part of its KRW 41 trillion (£24bn) stimulus package.

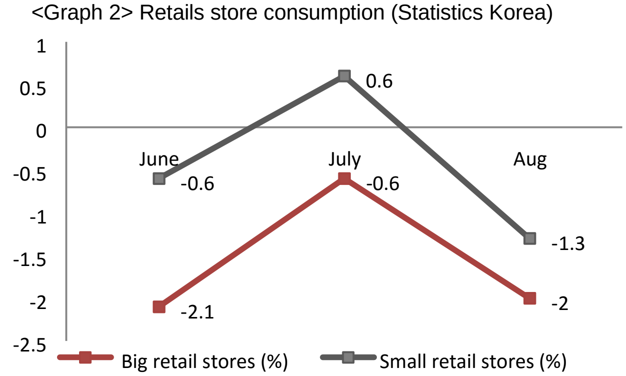
DPM Choi's decision reflects a wider Korean government concern that the economy is on a path of gradual deceleration; the Bank of Korea revised-down its 2014 GDP growth forecast to 3.5% on 15 October. This concern is backed up by a number of economic indicators:

- **Industrial output fell by 0.6% qoq (2.8% yoy) in August** after rising by 3.9% in July, following weaker export figures. Facility investment also decreased by 10.6%, the largest drop in 11 years. This drop is attributed to worsening corporate profits exacerbated by the weak Japanese Yen, as well as uncertainty about the effect of the government's stimulus package.

<Graph 1> IP and Facility Investment (Statistics Korea)



<Graph 2> Retails store consumption (Statistics Korea)



- **Export growth slowed to 1.7% yoy in September** (working-day adjusted), its lowest level since March. In particular, exports to Japan for January-September decreased 4.1% from the same period a year ago as Korea's SMEs faced difficulties in prices competitiveness due to the weak Japanese Yen.

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- **The forward-looking business confidence indicator (BSI) for the manufacturing sector also fell** from 75 points in August to 74 points in September. This drop marked the fourth consecutive fall in confidence and the lowest level since August 2013.

Why the wobble?

Why is there no noticeable recovery in the Korean economy despite the government's huge effort at stimulus? The problems are both internal and external, with analysts highlighting:

- **Political wrangling:** many bills closely linked to the government stimulus packages including the Service Industry Promotion bill and the Tourism Promotion bill have been delayed by the National Assembly. Uncertainty about the government's policies has also dampened economic activities including investment.

- **External risks:** the weak Japanese Yen is negatively affecting Korea's exports, and the sustained weakness in Chinese demand is creating additional pressure. The Korean Won appreciated against the Japanese Yen 10% year-to-date and 20% since Abenomics was introduced.

Deflation or stagflation?

DPM Choi believes the Korean economy is entering a stage of deflation (marked by a steady decline in the price of goods and services). Inflation hit a 7-month low in September when consumer price gains dropped to 1.1% from 1.4% in August. This rate is far below the central bank's 2.5-3.5% inflation target.

Some experts, however, believe the Korean economy is entering a stage of stagflation (a period of slow economic growth with rising consumer prices and high unemployment). They argue that although the overall inflation rate has remained below the Bank of Korea's target, prices closely linked to private consumption have increased. Gas rates, electricity rates and taxi fares rose 4.8%, 2.7% and 6.7% respectively, yoy, while the prices of pork, milk and eggs jumped 10%,

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11.4% and 7.4%. Core inflation[1] grew 2.4% over the last year, the fastest pace in two and a half years. Korea's official unemployment rate looks healthy at 3.1% for 2013, however, the real level is much higher since the Korean government does not include people seeking jobs for more than one year in its figures. Once these longer-term job-seekers are included, unemployment is believed to be around 7.2%.

The question of deflation versus stagflation is likely to create a headache for policymakers since moves to tackle deflation could in fact exacerbate stagflation by pushing up consumer prices. Consumers are already concerned about rising prices. This sentiment, coupled with the government's recently announced plans to hike cigarette and public utility prices are likely to exacerbate consumer debt, further dampening domestic consumption and growth.

Risk of low growth trap: real wage rise needed

The Korean economy has experienced continued growth over the past 20 years, but this growth has become increasingly decoupled from the majority of people's real wages, which have risen by less than half the rate of headline growth.

Korea's real wage growth rate has fallen to near zero, the lowest level in 2.5 years. The Ministry of Labour and the Bank of Korea (BOK) have noted that real wage growth continues to fall, dropping to 2.1% yoy in Q4 2013 and then to 0.2% in Q2 2014. The Bank of Korea said that corporate income has grown 9.4% annually from 1997 to 2012, nearly double the 5.5% average annual growth in worker income.

Deputy Prime Minister Choi has emphasised the importance of wage-led growth, saying that corporate earnings should lead to an increase in wages and a creation in jobs so that domestic consumption picks up. Choi announced measures to encourage corporations to stimulate the economy, including by taxing those that sit on large sums of capital while offering tax cuts to those that expand investments and raise wages. While analysts agree that real wages need to rise to lift the economy, they are doubtful that the corporations will adequately respond to the measures.

<Graph 3> Real Wage & Real GDP (McKinsey)

<Graph 4> Real Wage & GDP Growth Rates (MoL and BOK)

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[1] Core inflation refers to the price increase rate, excluding food and energy product prices.

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