KOREA ECONOMIC FOCUS

British Embassy Seoul

Slowing domestic consumption causing concern…

- Some leading think tanks and analysts are lowering their 2014 growth forecasts due to a slowdown in domestic consumption.

…but investment and exports are looking up

- Business and construction investment gained 2.6% and 6.9% respectively in April, while domestic machinery and construction orders grew by 26% and 42% yoy.

- Export growth also accelerated from 9% yoy in April to 12.4% in May despite the Korean won's strength.

Consumer confidence is downbeat

- The Sewol ferry disaster caused a drop in consumer sentiment and business activity.

Raising domestic consumption: a long term challenge

- Domestic consumption does not fully play its part as a driver of economic growth, with the economy still overly dependent on exports.

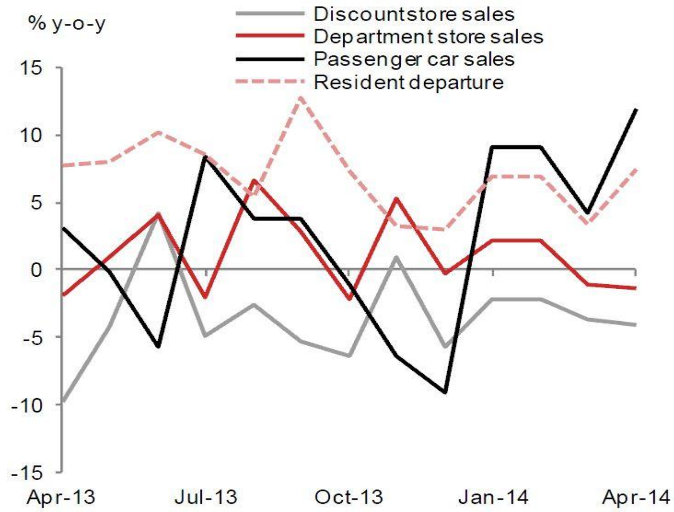
- Korea's private consumption is constrained by heavy spending on education, high levels of household debt, and a fast-ageing population.

Slowing domestic consumption causing concern…

While the Bank of Korea (BoK) and OECD recently forecast GDP growth to hit 4% in 2014, some key analysts are now less optimistic. The Korean Development Institute (KDI) revised down their outlook for 2014 by 0.2 percentage points to 3.7%.

KDI attribute their revision to sluggish domestic consumption. Many analysts, including in government, expected consumer spending to provide a push to the economy in 2014, but this has so far not materialised, with retail sales steadily declining through 2014. KDI consequently revised down their 2014 consumption growth forecast to 2.7% from an earlier forecast of 3.6%.

Chart 1: Consumption trend: retail sales slowing (Source: Nomura)



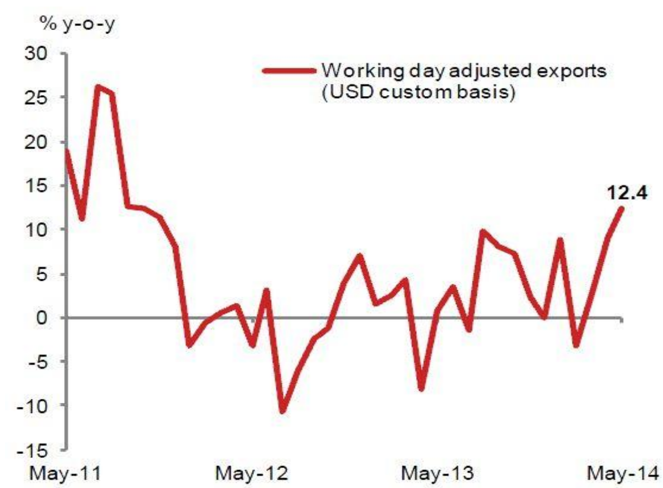
…but investment and exports are looking up

Alongside consumer spending, business investment and exports were expected to be the key sources of GDP growth in 2014. These two areas are looking up:

Business and construction investment gained 2.6% and 6.9%, respectively (SA month-on-month) in April, while domestic machinery and construction orders grew by 26% and 42% yoy.

Export growth also accelerated from 9% yoy in April to 12.4% in May, the first double-digit growth since November 2011. This is mainly due to a strong demand in electronic and automobile products from developed markets. Encouragingly, the current recovery of exports has occurred despite the Korean won's strength. In April, the won touched a six-year high against the US dollar.

Chart 2: Exports growth rate: looking up (Source: Nomura)



Why is consumer confidence down?

The recent downturn in domestic consumption was primarily caused by the Sewol ferry disaster. Most Korean individuals and businesses delayed or cancelled spending on entertainment, promotions and travel as a mark of condolence. Discount and department store sales fell 4.1% and 1.4%, respectively, yoy in April. Activity in culture, sports and leisure services dropped by 11.6% while accommodation and restaurant declined spending declined 3.2%. This trend continued through May (the month of mourning), with consumption patterns only beginning to return to normal in June.

The government, acutely aware of the economic impact, set out measures to speed up the consumption recovery and to support industries which had been affected. For example, loans worth KRW 50 billion are being provided to travel, transport and accommodation related businesses at a low interest rate of 2% and with a two-year grace period.

Consumption growth: a longer term challenge

While the recent decline in domestic consumption can be attributed to the Sewol ferry disaster, it is notable that private consumption has been subdued over the last 10 years. The Korea Development Institute (KDI), one of the largest government think-tanks, recently released a report expressing concern that domestic consumption does not fully play its part as a driver of economic growth.

For the last 10 years average annual consumption growth (3.2%) has been less than average annual GDP growth (4.1%). Between 2011 and 2013, disposable income increased by 11%, but consumption growth remained flat. President Park's three year economic plan, announced earlier this year, aims to reverse this trend, re-balancing the source of Korea's economic growth from exports towards domestic consumption. But much will depend on the success of widespread structural reforms set out in the plan.

KDI's report explained that growth in private consumption is mainly constrained by three key factors: (i) high household debt, (ii) heavy spending on education and (iii) Korea's ageing population. Let's look at these in turn:

(i) High household debt is the biggest short and medium-term risk for policymakers. As a symptom of easier credit such debt can be argued to facilitate consumer spending. However, with real wages declining for many, rising household debt (equivalent to 160% of disposable income and 77% of GDP in 2013) is adding a significant burden on private consumption growth.

(ii) Education costs are the main contributor to heavy spending in middle aged households. Koreans in their 40s typically spend 14% of their disposable income on their children's education (2003-2013 annual average). By contrast Americans in the same age group only spend 2.1% of their disposable income. This heavy focus on education spending means Koreans' lifetime consumption trends show a marked peak in spending in their 40s. This is broadly inconsistent with the pattern of consumption seen in most countries, where middle-aged households tend to save during their peak earning years (Charts 3 and 4).

Chart 3: Proportion of average spending against disposal income by age (KDI)

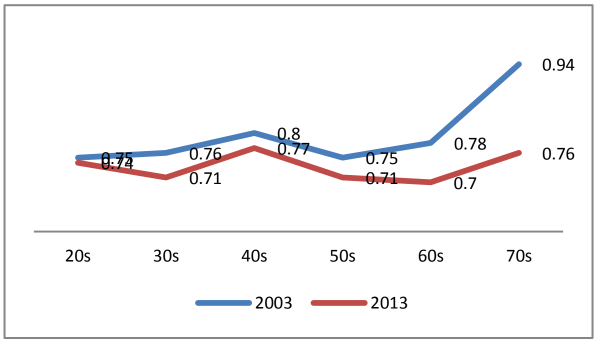
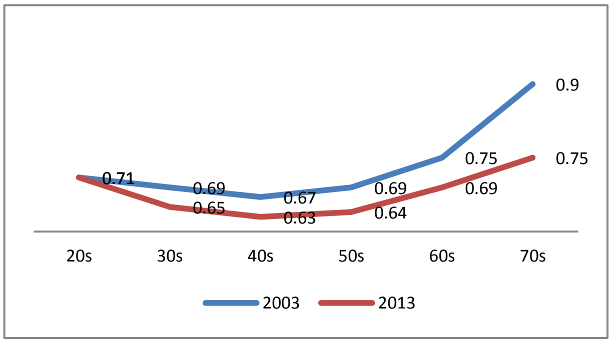


Chart 4: Proportion for average spending (excl. education) against disposal income by age (KDI)



This w-shaped spending pattern is widely recognised as a source of stress on individual families, but also on the economy as a whole. The OECD's report on 'growth and social cohesion in Korea' recommended employment and education reforms would be a key to sustaining output growth and reducing inequality.

(iii) Korea has the fastest aging population globally, and is projected to have the second oldest population after Japan by 2050 (OECD). Policymakers are acutely aware of the fiscal challenge resulting from a smaller proportion of the population in the workforce and larger part of it dependent on healthcare. This rapidly changing shift in demographics will have implications for both domestic production and consumption.

Current Korean spending patterns provide potential opportunities for UK businesses in education (particularly English language learning) and post-retirement healthcare. This trend is unlikely to change in the short to medium term, until households are better able to manage high levels of debt, and release more disposable income.