KOREA

Economic growth is projected to remain around 3% through 2019, supported by stronger export growth and fiscal stimulus that offset the impact of tighter regulations on housing and mortgage lending, which will slow construction investment. Inflation is projected to rise toward the 2% target, while the current account surplus narrows to around 4% of GDP.

The government's “income-led growth” strategy, driven by increased public employment, a sharp rise in the minimum wage and higher social spending, needs to be supported by structural reforms to narrow large productivity gaps between manufacturing and services, and large and small firms. The fiscal stimulus planned for 2018 is appropriate to support growth, but should be accompanied by a long-term fiscal framework to cope with population ageing, which will be the most rapid among OECD countries. With inflation below target, monetary accommodation should be withdrawn gradually.

Domestic demand is underpinning growth

A rebound in business investment and the continued strength of residential investment increased output growth to 3.1% in 2017, in line with Korea’s potential rate. Private consumption also strengthened as employment gains in 2017 offset a drop in real wage growth to 1.0%. Wages will pick up in 2018, given the 16.4% rise in the minimum wage. However, employment growth slowed markedly in the first quarter of 2018. In addition, the tightening of loan-to-value and debt-to-income regulations on mortgage lending has reduced the rise in residential property construction orders from a peak of 76% (year-on-year) to below 2%. Inflation, which surpassed 2% in mid-2017 as food and energy prices surged, slowed to 1.3% in early 2018.

Source: OECD Economic Outlook 103 database; and Bank of Korea.

1. Excludes food and energy. The central bank’s target is for CPI inflation.
2. A 24-month moving average.

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Structural reforms and fiscal measures are needed for inclusive growth

Raising labour productivity, which is 46% below that in the top half of OECD countries, is increasingly important as the working-age population peaked in 2017 and the government cut the statutory limit on weekly working hours from 68 to 52. The priority is regulatory reform, focusing on services, where labour productivity is less than half of that in Korean manufacturing. Policies to promote entrepreneurship and raise productivity in SMEs are also needed to sustain growth and reduce income inequality. Improving programmes that support SMEs to encourage higher productivity and reforming the insolvency framework to reduce the personal costs for failed entrepreneurs are priorities.

Fiscal policy is playing a key role in Korea’s income-led growth strategy. The government aims to boost public employment by 34% during its five-year mandate and shift the composition of spending away from public investment and R&D and towards social welfare. While public employment is low compared to other OECD countries, job creation in the public sector should respond to clearly defined needs and be weighed against its long-term cost. Although government spending is set to increase more than 7% in 2018, the highest since 2011, the budget surplus is projected to remain above 2% of GDP.

The Bank of Korea raised its policy interest rate from a record low 1¼ per cent to 1½ per cent in November 2017. With consumer price inflation running below 2%, monetary policy accommodation can be withdrawn gradually. Monetary policy needs to take into account
potential risks to financial stability, including those stemming from household debt, which rose to 180% of net household disposable income in 2016. The high debt is a headwind to private consumption. The government announced a comprehensive strategy in late-2017 that aims to slow the growth of household debt to less than 8.2% per year, notably by tightening regulations on lending to households.

**Korea is projected to maintain stable growth**

Growth is projected to remain close to Korea’s 3% potential rate, while inflation converges toward the 2% target. The rapid growth of government spending, in part to expand public employment, will help support domestic demand and reduce the current account surplus. The easing of geo-political tension related to North Korea is a positive development, although trade protectionism remains a concern. Another risk to the projection is the planned 54% hike in the minimum wage during the President’s five-year term. The higher minimum wage could lead to a faster increase in private consumption to the extent that it is enforced, but it could also slow employment growth and weaken Korea’s competitiveness if not accompanied by productivity gains. The measures to slow mortgage lending could turn the slowdown in housing investment into an outright decline.