KOREA

Economic growth continued at a moderate pace in 2016, supported by a supplementary budget and record low interest rates. Growth is projected to edge up from 2½ per cent in 2016-17 to 3% in 2018. Inflation is projected to converge to the central bank’s 2% target by 2018, and the current account surplus to remain large at 6½ per cent of GDP.

The Bank of Korea reduced its policy rate to an all-time low of 1¼ per cent in mid-2016. Concerns about rapidly rising household debt suggest fiscal policy may now be better placed to take some of the burden. The planned budget consolidation in 2017 will restrain growth. Instead, to support growth, government spending should be increased beyond the levels set in the National Fiscal Management Plan. In addition, structural reforms are needed to boost productivity and labour participation as the working-age population begins to decline.

Korea's persistent government surpluses and low public debt (around 45% of GDP) provide ample scope to increase spending in the near term, focusing on measures that would support its growth potential and social inclusion. The fiscal framework should be improved to provide more scope for short-term flexibility while maintaining a sound fiscal position, as Korea faces the most rapid population ageing in the OECD and the cost of possible rapprochement with North Korea.

Output growth remains below potential

Government policies continue to support the expansion. For the third time in four years, the government introduced in 2016 a supplementary budget, amounting to 0.6% of GDP. The relaxation of regulations on mortgage lending in 2013-14, combined with low interest rates, boosted residential investment growth to a 25% annual rate in the first three

1. By depository institutions.
2. Export performance is measured as actual growth in exports relative to the growth of the country’s export markets. OECD projection for 2016.

Source: Bank of Korea; and OECD Economic Outlook 100 database.
quarters of 2016, accounting for nearly half of the gains in real GDP. The accompanying rise in mortgage lending has pushed household debt above 170% of disposable income. Although export growth slowed to 1% in the first three quarters of 2016, the current account surplus reached around 7½ per cent of GDP and inflation remained below 1%.

**More expansionary macroeconomic policies and progress in structural reform are necessary**

With inflation well below the 2% target, the projection assumes that the monetary policy stance remains accommodative. However, the central bank is concerned that lower rates would further increase already high household debt, notwithstanding efforts by the financial supervisor to address the systemic risks to the financial system and the government’s tightening of regulations several times in 2016 to slow the growth of mortgage lending.

Supplementary budgets in 2015 and 2016 boosted central government spending significantly. As the prospect of further monetary expansion may be increasingly constrained, fiscal policy should be used more actively as a way of ensuring adequate aggregate demand. The fiscal position is strong and increased spending on priority areas, including investment to boost productivity and social spending, would be welcome.
However, in the absence of additional fiscal stimulus, spending growth in 2017-18 is set to slow. An improved fiscal framework is a priority to allow greater flexibility to help Korea break out of its low-growth trap while keeping public debt low over the long term.

Structural reforms are needed to boost labour productivity growth, which has slowed to an annual rate of less than 1% since 2011. The government has focused on regulatory reform, launching a “cost-in, cost-out” system to cap the regulatory burden on firms. This should be accompanied by labour market reforms to boost employment of women, youth and older persons and break down labour market dualism, thereby promoting socially-inclusive growth.

**Output growth is projected to edge up to 3% in 2018**

Output growth will be supported by the projected pick-up in world trade. This will also boost business investment, offsetting a gradual decline in residential investment following the tightening of regulations on mortgage lending. Private consumption is likely to gain traction as the household saving rate, which has risen from 4% in 2012 to nearly 9%, is expected to stabilise. With oil prices assumed to stay around recent levels, headline consumer price inflation is projected to rise to close to 2% in 2018, while the current account surplus falls to 6½ per cent of GDP.

Given Korea’s reliance on export-led growth, a delayed rebound in world trade is the biggest risk to achieving 3% output growth. In addition, recent problems in the mobile phone industry could have a temporary adverse impact on demand for Korean products. On the domestic side, political uncertainty poses a short-term risk, while the near-term impact of restructuring in troubled industries and the recent introduction of an anti-corruption law may be larger than expected. However, well designed fiscal stimulus and effective structural reforms could reignite domestic demand and reverse the decline in Korea’s export performance, leading to faster growth.