South Korean economy faces mounting problems

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There are signs of growing economic trouble in South Korea. The country, which is currently the world's 13th largest economy, is particularly vulnerable to the global economic turbulence. The financial shocks that began with the subprime mortgage crisis in the US loans last year, combined with global inflationary pressures, caught South Korea unprepared.

News of the bailout of the US mortgage giants—Fannie Mae and Freddie Mac—hit South Korea hard, with its share market plunging to a low for the year of 1,489.86 points. Economists and investors expressed concerns that South Korea may confront a combination of economic downturn, asset deflation, rising interest rates and inflation.

South Korea was in the midst of an aggressive expansion of bank lending when the international credit crunch hit in 2007. Small and medium enterprises (SMEs) and households are heavily indebted. Bank loans to SMEs stood at 398.9 trillion won ($US394.1 billion) in May, up 28.9 trillion won from December, while the overdue rate has increased to 1.3 percent in March, up from 1 percent in December.

Household debt has been growing even faster than the US. The total grew by 210 percent from 2001-2006, compared with 190 percent in the US for the same period. Total home mortgages reached 229 trillion won ($226.25 billion) in June, up 35.5 percent from 169 trillion won ($166.9 billion) at the end of 2004.

Although the housing prices in South Korea have not experienced a dramatic decline, rising mortgage interest rates—up 0.25 percent from April—are placing millions of families under enormous stress and raising the prospect of US-style home foreclosures. An unnamed Bank of Korea (BOK) official told the *Korea Times* on July 16 that it was still too early to talk about asset deflation. "However, if asset values drop by an additional 20 to 30 percent, chances are that the country will face another credit crisis," he said.

Andy Xie, former chief Asia economist with Morgan Stanley, pointed out that South Korea is vulnerable to stagflation—economic slowdown combined with rising prices. "Korea may be experiencing a massive property bubble funded by debt. A decline of asset values and a rise of the consumer price index (CPI) are a deadly combination."

The country's top business lobby, the Federation of Korean Industries (FKI), which is composed of major conglomerates such as Samsung and Hyundai, issued a statement on July 16 declaring that the South Korean economy "has already entered a period of stagflation". Federation chairman Cho Suck-rai said: "At this point, the government has little room to manoeuvre to overcome current economic difficulties."

The statement followed an emergency meeting of the FKI board. It passed a "Resolution to Boost the Nation's Economy", which stated: "We agreed that we should not sit idle while seeing the economy collapse." The 30 largest Korean corporations have agreed to spend 94.5 trillion won or $94 billion this year to stimulate the economy, up more than 25 percent from 2007. They also plan to create 39,000 jobs in the second half of the year, in addition to the 42,000 in the first half.

The statement came after the release of economic data for May by the National Statistical Office on July 7, which pointed to decreasing investment and dwindling production as well as weakening domestic demand. Mining and industrial production fell by 0.6 percent from April to May. Consumer sales shrank by 0.6 percent. Capital expenditure, a key indicator of business confidence, has fallen in four out of the five months from January to May.

The *Chosun Ilbo* pointed out that May, which has several public holidays, is traditionally a month with high demand for consumer goods. But this year, sales of durable goods such as cars, computers, telecom devices and furniture decreased by 2.2 percent compared to April, with semi-durable goods such as clothes and shoes down by 0.2 percent.

"The consumption trends show that consumers spent only on essentials and refrained from spending on items that were not urgently needed." Yoo Byung-kyu, a director of the Hyundai Economic Research Institute told *Chosun Ilbo*: "As the business outlook is seen as negative by businesses, apprehension took its toll and firms are unable to decide on what and when to invest."

Official statistics released on July 10 shows the consumer evaluation index in June at 61.3 (compared to a benchmark of 100). The indicator is based on a survey in which respondents are asked if their living standards have worsened compared to six months ago. The June figure is the lowest since September 2003—just before the credit card crisis that saw millions of people go into default. Inflation in June was 5.5 percent—the highest in more than nine years.

The administration of President Lee Myung-bak has been trying to downplay economic fears. On July 3, Finance Minister Kang Man-soo insisted there is no stagflation in South Korea, but has admitted that the economy "may be heading in" that direction.

However, Kang has been under mounting pressure to resign because of his policy of allowing the won to fall in value alongside the US dollar in a bid to keep the country's export prices competitive. His weak currency policy has been criticised for stoking inflation via high prices for imported raw materials, especially oil. South Korea recorded its first trade deficit in 11 years in June due to soaring oil prices, which cost an estimated record of $10 billion.

The combination of rising prices and a slowing economy has created a dilemma for the central bank. After much speculation of rate hikes to curb inflation, the BOK decided on July 10 to hold the rate unchanged at 5 percent for the 11th month in a row. BOK chief Lee Seong-tae told reporters: "[D]ecision-making is becoming more difficult with high inflation coinciding with an economic slowdown." Lee warned in particular against the demands for wage rises: "We are concerned about the secondary effect of rising inflation, such as a wage price spiral, in which inflation may creep into wages and increase inflation expectation."

Declining living standards and inflation have propelled hundreds of thousands into the streets in recent weeks. While opposition to US beef imports and concern about mad cow disease has been a trigger, the extent of the movement points to broader concerns about economic uncertainty, declining living standards, price rises and job losses. A wave of strikes by truck drivers over high fuel prices has rocked South Korea in recent weeks.

President Lee was forced to carry out a cabinet reshuffle on July 7 to try to stem the mass protests over US beef imports. All ministers tendered their resignations and three were replaced.

Lee, from the right-wing Grand National Party, won the presidential election last year by capitalising on widespread discontent over the state of the economy. His grand plan, known as "747," promised 7 percent annual growth rate, doubling per capita income to $40,000 and making South Korea the world's seventh largest economy.

Since his installation in February, Lee's program has quickly fallen apart. The latest government estimate for the growth rate is now in the upper 4 percent range. However, Finance Minister Kang Man-soo admitted recently that if the oil price hits $170 a barrel, the growth rate might slip to 3 percent and inflation rise to 6 percent. Seoul is preparing to enforce emergency energy conservation measures if oil prices reach $150.

Earlier this month, Seoul decided to strengthen the won by intervening into the currency market. At one point, the won hit 993 against the greenback on July 9—from 1004.9 the previous day—the biggest jump since the October 1998. The government is believed to have sold $10 billion from its foreign currency reserves. International financial institutions, however, have put a big question mark over the government's measures, due to the weakening US dollar and rising oil prices. Standard & Poor's declared that such measures could not halt the decline of the won in the long term. Morgan Stanley predicted the intervention would "ultimately fail".

Foreign investors are losing confidence over the South Korean economy, selling off 17.4 trillion won in shares this year—the highest sales level since the Seoul stock exchange was opened to foreigners in 1992. Foreign stock holdings have fallen from 44 percent of the domestic capital market in 2004, to 31.35 percent. A major concern among foreign investors is political instability. The *Wall Street Journal* wrote on July 7: "It's unclear how much longer the [anti-US beef] movement will sustain momentum, as sentiment rises that the protests may be distracting the government from addressing major economic problems."

South Korean investment overseas has also been suffering, the *Chosun Ilbo* reported on July 15. Fuelled by a flood of cheap credit, South Korean investors last year bought $52.4 billion in foreign stock—a more than threefold increase from 2006. By the end of 2007, South Korea held $116.6 billion in foreign funds, including bonds, with returns of 9 trillion won. This year, however, amid global financial turmoil, losses are estimated to be close at 12 trillion won. Last year's profits have been wiped out and the value of investments is dwindling.

South Korea is highly exposed to global economic changes because of its dependence on exports of manufactured goods to Western markets, and imports of raw materials. It is the world's fifth largest importer of oil and also buys large quantities of iron ore, coal and other minerals. Weakening demand in the US and Europe is having a major impact on Korean exporters. In the first half of this year, South Korea's trade surplus with the US fell by 38.3 percent from the same period last year to just $2.8 billion. Exports to China, now South Korea's largest trade partner, continue to increase, but China is rapidly becoming an economic competitor to South Korea.

South Korean corporations confront a difficult dilemma: squeezed on the one side by Japanese, European and American rivals who currently hold an advantage in advanced technology, and on the other by emerging economies, particularly China, which is increasingly involved in the manufacture of more sophisticated products including electronics and cars. South Korean firms, particularly in labour intensive industries, are increasingly looking for cheap labour in South East Asia and also in North Korea, which only compounds the social crisis at home. The fact that South Korea is no longer seen as an attractive manufacturing platform is indicated by the decline in foreign direct investment (FDI) over the past three years—its OECD ranking for FDI has plunged from 16th in 2004 to 29th last year—almost at the bottom.

The latest data indicates that these broader processes are producing a major economic crisis, which will intensify the country's political and social turmoil.