South Korean president Park Geun-hye’s Saenuri Party suffered a surprise defeat in legislative elections held on April 13, failing to secure a majority in the National Assembly. Saenuri’s defeat was largely attributed to dissatisfaction with the state of the economy. Voters have reason to worry. The slowdown in China and weak growth in other major economies, coupled with demographic decline, high household debt, and low productivity at home, are putting Korea in an increasingly challenging economic bind. As President Park enters the final 18 months of her administration, Korean economic policymakers must reckon with both unique problems at home and stronger international headwinds.

Since the global financial crisis, Korea’s real gross domestic product (GDP) has grown at an average annual rate of 3.1 percent, relatively high by the standards of other advanced economies. But another poor showing in the first quarter of this year and a downgrading of the outlook for 2016 to only 2.7 percent show that Korean growth is clearly underperforming. This is worrisome for a country that still ranked just 19th in per capita income among Organization for Economic Cooperation and Development (OECD) countries in 2014 and has a long way to reach the living standards of Japan or the United States.

For all its enviable strengths, Korea faces a host of domestic economic problems. The most troubling is the country’s demographic outlook. Korea has one of the lowest fertility rates in the world, its working-age population is projected to peak this year, and it is expected to be among the world’s oldest countries by 2050. Although the country’s public finances are currently in good health, with a government debt burden of just 54 percent of GDP, policymakers will have to reckon with rapidly rising social expenditures for years to come. Korean productivity will need to grow consistently for the country to sustain higher growth rates and avoid a crushing public debt burden. Yet while the country’s manufacturing sector productivity is among the highest in the world, it suffers from persistently low service-sector and labor-productivity growth compared to its OECD peers. Partially as a result of low productivity and demographics, investment has continued to decline as a share of GDP. In theory, consumption could pick up some of the slack, but this has been held back by an alarming rise in household debt.

Household debt in Korea has reached staggeringly high levels, driven largely by rising mortgage debt. Today the ratio of household debt to disposable income is more than 160 percent, far above the OECD average of 135 percent. The government has tried to balance the need to rein in mortgage debt with supporting the housing market, since almost 70 percent of household wealth is concentrated in real estate, but to little effect. In a country with rising inequality, housing remains the most important asset for middle-class Koreans. Thankfully, balance sheets are strong, with most debt matched by high asset values. However, the big fear is that, as Bank of Korea governor Lee Ju-yeol said in a June 2015 speech, if household debt keeps rising it may restrain household spending and destabilize the financial system.

The Park administration clearly understands the need for structural reforms to deal with these challenges and deliver the productivity gains the country needs. But progress on reform, most importantly in the labor market, has been halting. Korea suffers from a highly rigid labor market, with regular workers accounting for less than 50 percent of total employees in 2015 because of the difficulty for companies trying to fire regular workers and for temporary workers to become full time. Multiple times over the past year, the government has attempted to push labor market reform that would introduce more merit-based pay scales and make it easier to fire underperforming employees, but its efforts have consistently lacked support in the National Assembly. A similar fate has befallen the government’s efforts to introduce a services industry bill that would deregulate many protected professions and could achieve significant service-sector productivity gains.
As much difficulty as Park has had advancing her structural reform agenda, external economic conditions have added a new challenge for Korean policymakers. Korea’s economic miracle over the past three decades derived in no small part from its sizeable manufacturing and export sectors. Manufacturing accounted for over 30 percent of GDP in 2014, with total exports over 50 percent of GDP, even higher than Germany’s. Korea’s enormous export sector is a testament to how deeply the country is embedded in the global trade system. The country is at the heart of Asia’s supply chains as well, with nearly two-thirds of its exports and imports going to and coming from the rest of the region. While this openness has been hugely advantageous in powering the country’s development, these linkages have also left it exposed to increasingly negative external conditions.

The slowdown in China has become especially worrisome as Beijing has appeared less committed to pursuing reform. Declining exports to China over the past year have been a significant external drag on Korean trade. Nearly 25 percent of Korean exports go to China, but overall Korean export prices have declined by 8 percent from 2007 to 2014. And despite the two countries signing a free-trade agreement last year, outside observers do not believe it will deliver substantive gains for Korea. Moreover, China has begun to move into sectors Korea has traditionally excelled in, notably automobiles, where China’s global export market share has crept up from 2.9 percent in 2007 to 5 percent in 2014. Although Korea still enjoys a formidable technological lead over China, its rigid labor market has contributed to rising labor costs even with low productivity growth.

Korea has also been buffeted by other external forces. Over the past year, the Federal Reserve’s move toward higher interest rates in the United States has strengthened the dollar, putting downward pressure on the won. Yet a weaker won has not delivered expected trade gains—just more warnings from the U.S. Treasury not to use currency intervention as a tool to gain trade advantage. Meanwhile, despite Seoul’s efforts to forge bilateral trade agreements, not joining the Trans-Pacific Partnership (TPP) is expected to have a diversionary effect on Korean exports over the coming years, an outcome that clearly worries policymakers in Seoul.

Following the disappointing legislative election results, President Park now enters the final 18 months of her term before the next election in December 2017 with little hope for meaningful policy change until then. Tensions with North Korea have increasingly dominated the president’s agenda and cast a shadow over politics and policy in Seoul. Increased government spending may be the only area of compromise between Park and the opposition Minjoo Party and People’s Party that together now hold a majority in the National Assembly. The difficult structural reforms are likely to have to wait for a post-Park administration. For the new leader, joining TPP should be a first order of business, to help push domestic reform and reduce Korea’s troubling overdependence on trade with China.

Simon Says...

Simon lives life by the maxim that a city can never have enough coffee shops, but the Korean capital may be testing this proposition. Some parts of Seoul are currently facing a café boom, with reports that nearly one in every two buildings in some retail and commercial districts houses a coffee shop. Even convenience stores, pubs, and restaurants are adding coffee to their menus. Seoul now has more coffee shops per capita than Seattle or San Francisco, bastions of American coffee consumption.

The good news for consumers is that this is delivering something Korean policymakers desperately wish could be applied to other industries: competition. As profits are squeezed, shops have cut prices, streamlined their staffs, and differentiated their products, all to raise productivity and attract customers. This is also pushing Korean coffee brands overseas in search of new markets, with even small premium brands investing in China and Southeast Asia.

This competition has been driven in no small measure by foreign investment. Starbucks’ arrival in South Korea in 1999 is widely acknowledged with sparking the country’s habit for higher-quality coffee and establishing a nascent café culture. While South Korea’s annual per capita coffee consumption has nearly doubled since 1990 to 5 lbs. per person, this is still only about half of American consumption levels. Unlike their counterparts in many foreign cities, Korean consumers can look forward to low prices for some time to come. Simon just hopes that such homebrewed competition—and caffeine—can raise service-sector productivity.