

# The south korean economy economics essay



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The purpose of this project is to study the various facets of the South Korean Economy and thereby analyse through various indicators the current economic condition. Also the project aims at understanding how monetary policy, fiscal policy and trade policy have been used to control various macroeconomic parameters and how they have impacted the economy and played a crucial role in the development and performance of the economy of South Korea as a whole.

The stress of this project would however remain on better understanding of Macroeconomic concepts and thereby linking them as and when necessary to support a claim or point out the flaws in the policies if any.

## **Introduction to South Korea**

South Korea, also called the Republic of Korea is surrounded by China in the west, Japan in the east, the Korea Strait in the south and North Korea in the north. The total land area of South Korea is 99, 392 square km. and has a population of 50 million. The capital and largest city of the country is Seoul.

South Korea is a Presidential Republic and one of the developed countries with a very high standard of living. The national currency is South Korean Won (KRW) issued by The Bank of Korea since June 12, 1950. The South Korean Won is not regulated by any governing body, but determined by the demand and supply dynamics in the market.

It is Asia's fourth largest economy and the world's 15th (nominal GDP) or 12th (GDP PPP) largest economy which puts it in the elite G-20 major economies. South Korea is a member of the United Nations, WTO, and OECD. It is also a founding member of APEC and the East Asia Summit.

Owing to its rapid and consistent growth given the scarce nature of natural resources allotted post the liberation of the country, it is often referred to as, “ The Miracle on the Han River.”

We have observed from the above graph that the GDP of South Korea from 1961-2011 has been growing at a good pace. Especially during 1960-1980, the country experienced a rapid growth. In 1998 the GDP data however shows a slump which mainly accounts due to the Asian Financial Crisis.

South Korea’s economic profile has won a string of plaudits, including:

World’s 8th largest exporter: Ahead of the UK, Russia and Canada.

World’s Trading Partner: 3rd largest trader with China and Japan, 7th with the US and 8th with the EU.

World’s largest shipbuilder: including world’s largest shipyard run by Hyundai Heavy Industries.

World’s 5th largest automobile manufacturer: including world’s largest automobile assembly plant (Hyundai Motors).

World’s largest electronics manufacturing firm: Samsung electronics.

World’s largest producer of computer memory chips.

South Korea’s Export structure has changed over the period of time. We observe, it has shifted from Agriculture products to Light Industry products to HCI products over the period of time.

The next page shows the major economic indicators for South Korea. It also includes a few forecasts made by IMF for the year 2012 earlier in 2011.

## **Government Spending**

Of the 20 largest economies, only six spent less per citizen. South Korea spending \$4, 557 per citizen is one of them. The General government consumption expenditure (% of GDP) in South Korea was last reported at 27. 3% in 2011, according to the 2012 Index of Economic Freedom by The Heritage Foundation and The Wall Street Journal.

The Health expenditure; public (% of government expenditure) in South Korea was last reported at 12. 36% in 2010, according to a World Bank report published in 2012. Public health expenditure consists of recurrent and capital spending from government (central and local) budgets, external borrowings and grants (including donations from international agencies and nongovernmental organizations), and social (or compulsory) health insurance funds.

It has to be noted that South Korea Government spending spends mostly on Economic affairs in the country, followed by education, defence, general public services, Health, social protection, public order and safety, amenities for housing and communities and environment protection. Historical data for government spending as compared to all other countries is as follows:

## **Consumption**

The Household consumption expenditure (% of GDP) in South Korea was last reported at 3. 5% in 2011, according to a World Bank report published in 2012. It was seen that the consumer spending in South Korea has been

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falling slowly from 2008 to 2011. Household consumption expenditure is the market value of all goods and services, including durable products, purchased by households. Here, household consumption expenditure includes the expenditures of non-profit institutions serving households.

Analysis of the consumption structure of households in Korea based on 'Population Projections' and 'Household Income and Expenditure Survey' compiled by Statistics Korea shows that, amid rapid population aging, the income distribution structure is worsening in the Korean economy. For households whose head is aged over 60 with income growth remaining a low level and the income disparity deteriorating, in particular, the average propensity to consume becomes lower, which is analyzed as possibly acting as a factor impeding consumption dynamism of the Korean economy.

Analysis based on an Almost Ideal Demand System (AIDS) carried out by Bank of Korea reveals that education, transport, miscellaneous goods and services are generally looked on as luxury goods, while housing, water, electricity and other fuels, restaurants and hotels, food and non-alcoholic beverages and communication are seen as necessary goods, although there are slight differences depending upon factors such as income quintile and the age of the household head. By item, education shows high elasticity to income regardless of income quintile, but by age of household head, its elasticity is higher particularly in households whose head is aged 40 to 50. The higher the income level, the greater transport's elasticity to income becomes. And, by age of household head, its elasticity is greater in those households whose head is aged lesser than 40 or over 60. Miscellaneous goods and services' elasticity to income is high mostly in households with a

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head aged less than 40, and that of health is high in low-income households whose head is aged over 60.

The annual growth of Korea's consumer spending ran lower than that of the economic growth between the third quarter of 2009 and the second quarter of 2011, marking the longest streak of such a trend, according to data by the central bank and the Samsung Economic Research Institute.

The average growth rate of consumer spending reached 2.96% during the cited period, lower than an average of 4.4% for the quarterly economic forecast.

The concern is the growth momentum of the Korean economy has been weakening amid sputtering domestic demand. Given that exports, which account for most part of the economy, are cooling due to the global slowdown, weak domestic demand is feared to further dent Asia's fourth-largest economy.

## **Investment**

The Investment in South Korea as a part of GDP was 27.4% in 2011. Gross fixed investment is defined as total business spending on fixed assets, such as factories, machinery, equipment, dwellings, and inventories of raw materials, which provide the basis for future production. It is measured gross of the depreciation of the assets, i. e., it includes investment that merely replaces worn-out or scrapped capital.

It is observed that the gross investment in South Korea as a part of GDP is fluctuating between 27% to 30%. Owing to its manufacturing based

companies like LG, Daewoo, Posco steel, Samsung, etc. a lot of business investment takes place in here. This further fuels up the economy as these manufacturers export a lot of goods thus strengthening the economic growth. There is a lot of growth opportunity as the investments will result in growth as a result investments funded by savings as well as FDIs can benefit the country.

## **Exports**

Exports in South Korea decreased to 45097 USD Million in December of 2012 from 47778. 72 USD Million in November of 2012. Exports in South Korea are reported by the Ministry of Knowledge Economy.

Historically, from 1966 until 2012, South Korea Exports averaged 10919. 20 USD Million reaching an all-time high of 48950. 11 USD Million in July of 2011 and a record low of 14. 75 USD Million in January of 1966. South Korea relies largely upon exports to fuel the growth of its economy. The most important exports are finished products such electronics, semiconductors, LCD panel, mobile phone, computers related, television, motor vehicle, steel, ships and petrochemicals. Main export partners are China, European Union, U. S. and Japan.

South Korea is an export-orientated country, with a total trade volume of 884. 2 billion in 2010. This figure makes them the 7th largest exporter and 10th largest importer in the world. Since 2003, it has established its network of free trade agreements (FTA) to boost trade and economic ties with other countries and making favourable conditions for an open economy. The exports of South Korea have fuelled its growth over the years and its various

exports are world famous brands like Samsung, LG, Daewoo, Posco steel, etc.

Currently, South Korea has 5 FTAs in effect, 3 FTAs which has concluded discussions, and 19 FTAs under negotiation and consideration. So far, the biggest FTA of South Korea is the Korea-US Free Trade Agreement (KORUS FTA) signed in 2007. This free trade agreement plans to liberate 95% of the trade tariffs between the 2 countries. It is also US first free trade agreement with a major Asian economy and biggest deal since the North America Free Trade Agreement (NAFTA) signed with Japan in 1993.

South Korea's Export Statistics at a Glance (2010)

Total value of exports: US\$466. 3 billion

Primary export – commodities: semiconductors, wireless telecommunications equipment, motor vehicles, computers, steel ships, petrochemicals

Primary export partners: China (23. 2 percent of total exports), US (10. 1 percent), Japan (5. 8 percent), Hong Kong (5. 3 percent)

## **Imports**

With a lack in natural resources, South Korea has a high dependence on import of capital goods, raw materials and industrial supplies. The country is also the 5th largest importer of oil in the world, with 3. 074 million barrels imported per day. South Korea has to import a lot as it has subsequently shifted from an agrarian economy to a manufacturing-service economy.

Imports in South Korea decreased to 43072 USD Million in December of 2012 from 43398. 23 USD Million in November of 2012.

Imports in South Korea are reported by the Ministry of Knowledge Economy. South Korea imports mainly machinery, electronics and electronic equipment, oil, steel, transport equipment, organic chemicals and plastics. Its principal import partners are: China, Japan, United States, European Union and Saudi Arabia.

South Korea's Import Statistics at a Glance (2010)

Total value of imports: US\$417. 9 billion

Primary imports – commodities: Machinery, electronics and electronic equipment, oil, steel, transport equipment, organic chemicals, plastics

Primary imports partners: China (16. 8% of total imports), Japan (15. 3%), US (9%), Saudi Arabia (6. 1 %), Australia (4. 6%)

## **Fiscal Policies and Deficits**

South Korea recorded a Government Budget deficit equal to 2% of the GDP in 2011. From 1988 to 2011, South Korea Government Budget averaged (-)0. 1% of GDP reaching an all-time high of 3. 5% of GDP in December of 2007 and a record low of (-)4. 1% of GDP in December of 2009.

Historical Data Chart

As a result of a series of policy interventions to spur economic growth, the Korean economy has recovered substantially from the global financial crisis that began in mid-2007. However, fiscal responses to the financial crises of <https://assignbuster.com/the-south-korean-economy-economics-essay/>

1997-1998 and 2007-2010 led to a rapid accumulation of budget deficits and national debt. The Korean government has had a budget deficit nearly every year since 1997. Korea faced extreme fiscal challenges during the financial crisis of 1997-1998 and increased its borrowing to speed the recovery. Recovery from the crisis resulted in greater debt than had been recorded during the crisis.

South Korea recorded a Government Debt to GDP of 34 percent of the country's Gross Domestic Product in 2011. Government Debt to GDP in South Korea is reported by the International Monetary Fund. Historically, from 1990 until 2011, South Korea Government Debt to GDP averaged 19.4% reaching an all-time high of 34.0% in December of 2011 and a record low of 8.0% in December of 1996.

#### Historical Data Chart

South Korea's unified budget balance includes the Social Security Funds balance. The surplus in the Social Security Funds therefore offsets the budget deficit, making Korea's national budget appear more balanced than it actually is. Excluding Social Security Funds, South Korea's consolidated central government balance (the fiscal deficit) rose to 4.1% of GDP in 2009 and declined to 1.1% of GDP in 2010.

Deficit increases from 2008 to 2011 were mainly the result of supportive policy measures introduced during the global financial crisis. Although the budgets of fiscal years 2010 and 2011 imply some fiscal restraint relative to 2009, they still show an expansionary trend compared with pre-crisis levels, which ranged from -1.3% of GDP to 0.7% during 2000-2007. From 2008 to

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2011, the Korean government recorded the largest budget deficits since 2000. As a result of these accumulating deficits, the national debt has soared. During that crisis, public funds to rescue troubled financial institutions were raised mainly through the issuance of bonds by the Korea Deposit Insurance Corporation (KDIC) and the Korea Asset Management Corporation (KAMCO). The debt created by these government-guaranteed KDIC/KAMCO bonds did not count toward Korea's national debt.

From 2003 to 2006, KDIC/KAMCO bonds worth 49 trillion won were converted into treasury bonds, shifting the debt to Korea's national balance sheet and resulting in a record increase in the national debt.

### **Five year plan 2009-13 (Plan for green growth)**

The Five-Year Plan (2009-13) contains about 600 projects and a total budget of 108.7 trillion won (10% of 2009 GDP). Public R&D accounts for 11% of the total budget allocation motivated by the need to overcome market failures.

The government is pursuing various approaches to supply funds and overcome financial constraints. Bank loans to green industries amounted to 2% of their corporate lending during the first half of the Five-Year Plan, with state-owned banks accounting for three-quarters of the loans. Such lending was encouraged by large credit guarantees provided by public institutions. Meanwhile, investment in green industries through the venture capital market nearly doubled between 2009 and 2011, rising to around half of total venture capital investment. Public funds were invested in 83 venture businesses. Korea is looking to channel more of these funds through existing market-based systems and commercial institutions, thereby reducing the

role of state-owned banks and public funds. Korea's energy intensity is declining but remains well above the OECD average.

## **Taxation System in South Korea**

In order to fund various fiscal policies taken, the government has to rely heavily on the revenues generated through taxes so that the public debt does not cross over high values.

The Korean tax system is comprised of both national and local taxes, the latter of which are imposed by provinces, countries and municipalities. Examples of local taxes include property tax, automobile tax, license tax and registration tax. National taxes, on the other hand, are currently made up of internet tax, custom duties, and education tax, international tax, which consists of direct tax and indirect tax, is thus the most significant type of tax payable in Korea.

Corporation tax: A corporation having its head office or its main office in Korea is liable to the corporation tax. The corporation tax is assessed on the income accruing in each business year, the liquidation income, and the capital gains. The amount of corporation tax on the income of a domestic corporation for each business year shall be an amount calculated by applying tax rates to the amount of tax base.

Korea has a progressive taxation system with the following brackets:

Personal Income Tax:

Earnings up to W12million Tax Rate is 6%

From W12 million to W46 million Tax Rate is 16%

From W46 million to W88 million Tax Rate is 25%

Earnings over W88 million Tax Rate is 35%

Resident Surtax:

All residents (Korean and Foreign) pay a resident surtax, which is 10% of their taxable income.

Corporate Profit Tax:

Income up to W200million Tax Rate is 10%

Income over W200 million Tax Rate is 22%

In addition to the basic tax rate, there is a resident surtax (inhabitant tax) of 10% of the corporate income tax liability.

Hence maximum payable tax would be:

Personal income tax- 38. 5%

Corporate profit tax- 24. 2%

The tax revenue was reported to be 15. 15% of GDP in 2010.

## **Monetary Policies**

### **Inflation Targeting**

The Bank of Korea has been adapting inflation targeting as its monetary policy framework. Inflation targeting is a operational framework of monetary

policy focusing on the ultimate goal for 'inflation' itself and aiming to achieve its goal over the mid-term horizon, instead of setting intermediate targets such as 'money supply' or 'exchange rates' and influencing them thus to achieve the ultimate goal of price stability.

The Bank of Korea sets the mid-term inflation target to be applied for three years in consultation with the government. The inflation target measure during the period from 2010 to 2012 was set at  $3.0 \pm 1\%$ , based on consumer price inflation. The Bank of Korea pursues the anchor for inflation expectations by working towards keeping the inflation rate from deviating too widely from the mid-point of the mid-term inflation target range (3.0%). In addition, the Bank of Korea also gives explanation to the general public as to the status of the operation of the medium term inflation target by monitoring it on an annual basis.

Inflation in South Korea in December 2012 was recorded at 1.40%.

## **Inflation History**

Historically, from 1966 until 2012, South Korea Inflation Rate averaged 8.09% reaching an all-time high of 32.51% in October of 1980 and a record low of 0.17% in February of 1999.

In South Korea, the most important categories in the consumer price index are Housing, water, electricity, gas and other fuels (17% of total weight) and Food and non-alcoholic beverage (13.6%). Others include Restaurants and hotels (12%); Education (11.4%); Transportation (10.9%); Health (7.3%); and Clothing and footwear (6.2%). The components with the least weight are Communication at 5.8%; Recreation and culture at 5.3%; Furnishings,

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household equipment and routine maintenance at 3. 8%; and Alcoholic beverages and tobacco at 1. 24%.

The inflation chart and table below feature an overview of the South Korean inflation in 2012; the average inflation rate in South Korea is 1. 87%

C: UsersSonamDesktopinflation 2012. jpg

In July 2012 the Bank of Korea downgraded its full-year growth forecast from 3. 5 per cent to 3 per cent, but economists warn that even the revised prediction could prove optimistic, as confidence wanes among both consumers and businesses.

The low inflation rate is well below the Bank of Korea's stated target range of 2 to 4%. It may give policy makers scope for more aggressive intervention to support the economy. It cut base rate in July by 25 basis points to 3 per cent.

## **Base Rate Policy**

The Bank of Korea Base Rate is the reference policy rate applied in transactions between the Bank of Korea and financial institutions, such as the Bank's liquidity adjustment deposits and loans.

The Monetary Policy Committee of the Bank of Korea determines the Base Rate taking into overall consideration the monthly price movements, domestic and overseas economic and financial market conditions and so on, the Base Rate has a prompt impact on the call rate, i. e. overnight inter-bank lending rate, and this leads to changes in short- and long-term market rates and deposit and loan rates, thus ultimately influencing activities in the real economy.

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## **Policy Response to the Global Financial Crisis (2008)**

The Bank of Korea brought its Base Rate down substantially from 5.25% to 2.0%, between 2008 October and February of 2009. The Bank also lowered the interest rate on its Aggregate Credit Ceiling Loans from 3.5% to 1.25%

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The Bank lowered its Base Rate on two occasions in October 2008, by 1.0 percentage point in total. This was followed by cuts of 0.25 percentage point in November, 1.0 percentage point in December and 0.5 percentage point in both January and February 2009. In all, the Bank cut the Base Rate by a total of 3.25 percentage points in a series of six steps. As a result the Base Rate declined to 2.0%, its lowest level since the policy rate target began to be announced in May 1999.

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The rationale for lowering the policy rate so steeply in such a short period was the need to respond actively to the situation in which the real economy had contracted rapidly while the financial and foreign exchange markets had shown disturbingly unstable movements from September 2008 onwards. In particular, it was essential to undertake very resolute and swift policy actions to prevent a vicious spiral in which a drop in business activity caused by the financial market unrest brings about even severer financial market turmoil.

## **Reserve Requirements**

The Monetary Policy Committee determines reserve requirement ratios within a range 0% to 50%. Each financial institution is required to maintain

minimum reserves against its liabilities subject to reserve requirements, which are calculated monthly, from the first to the last day of the month or based on the daily average outstanding balance of liabilities. Reserve ratio.

.jpg

## **Foreign Exchange**

South Korea shifted from a fixed foreign exchange system to a floating (Managed float) system due to the changing needs of the economy.

The Korean government put its first 5-year Economic Development Plan into action in 1962 and needed to use foreign capital as efficiently as possible to develop the economy. The Foreign Exchange Management Act was enacted for that purpose in December 1961. Until 1980, the government strictly regulated foreign exchange transactions, and the Korean won was pegged to the U. S. dollar.

As the current account moved into surplus, which was sustained for four consecutive years from 1986, Korea clearly set out its policy on foreign exchange liberalization by accepting the obligations of Article VIII of the IMF Agreement in November 1988. Since then, the system of foreign exchange controls has been largely dismantled.

From 1990 onward, a series of deregulatory measures was put in place to meet the increasing need for liberalization to improve the efficiency of domestic financial markets and to respond effectively to the rapid changes in international financial markets.

The adoption of the Market Average Exchange Rate System in March 1990, the Korean won-U. S. dollar rate began to be determined on the basis of underlying demand-supply conditions in the interbank market, although daily fluctuations were limited within certain bands.

The central bank however takes a few corrective measures in order to stabilise some disorderly movements caused by a herd behaviour.

On 28th January 2013: 1093. 80KRW (South Korean Won) = 1 USD.

## **Trade Policies**

In the past, South Korea's trade policy placed heavy emphasis on import control and export growth promotion. South Korea revised its trade policy to a more neutral stance in recent years, which includes, amongst other things, reaching free trade agreements (FTAs) with other countries. It has entered into FTAs with Chile, Singapore, Peru, the European Free Trade Association (Switzerland, Norway, Iceland and Lichtenstein), ASEAN, the EU and the US. The FTA with the US was ratified in November 2011. A Closer Economic Partnership Agreement between South Korea and India was signed in 2010.

On the other hand, South Korea began FTA negotiations with China in May 2012, while considering FTAs with countries including Japan and Indonesia. A South Korea-China FTA has significant implications for both parties with bilateral trade reaching US\$221 billion in 2011. In comparison, South Korea's bilateral trade with the US and EU in 2011 were, respectively, US\$101 billion and US\$103 billion.

In 1997, South Korea simplified import procedures and required documentation. Most goods can now be imported without licences, except items restricted for health or security reasons. All of Hong Kong's leading export products can be freely imported into South Korea.

Most duties are assessed on an ad valorem basis. For non-agricultural products, over 90% of goods are charged at tariff rates from 0% to 10%. Tariff rates for leading import items (e. g. electrical machinery) from Hong Kong range between 0% and 13%.

In addition to tariffs, imports are also subject to other taxes, including a value-added tax (VAT). In addition, a special excise tax, which ranges from 10% to 20%, is levied on certain luxury and durable consumer items.

The South Korean government still maintains a safeguard mechanism, which allows the government to impose a maximum of 100% tariff on goods which might disrupt the local markets. For example, jewellery is taxed at up to 65% and perfume is taxed at up to 35% (comprising regular tariffs, special excise tax and value added tax).

The Current account balance (BoP; US dollar) in South Korea was last reported at 26505331262. 97 in 2011, according to a World Bank report published in 2012. Current account balance is the sum of net exports of goods, services, net income, and net current transfers. Data are in current U. S. dollars.

The BOP graph shows that the Bop which was once in surplus has now gone into deficit. This is mostly after the 1997 Asian crisis. The imports of South

Korea have increased considerably and the value of exports haven't been able to match up.

## **UNEMPLOYMENT**

South Korea faces the problem of a rapidly aging population. The percentage of elderly aged 65 and above has sharply risen from 3.3% in 1955 to 10.7% in 2009. The shape of its population has changed from a pyramid in the 1990s, with more young people and fewer old people, to a diamond shape in 2010, with lesser young people and a large proportion of middle-age individuals.

Hence, there would be a decrease in the percentage of economically active people in the population. Also, with rapid aging, it is highly likely that there would be an imbalance in the young-old percentage of the workforce leading to a lack of vibrancy and innovation in the labour force.

A possible consequence might be that South Korea would be a less attractive candidate for investment. Investors might decide to relocate to countries like Vietnam and China, where there is an abundance of cheaper, younger labour.

The unemployed persons were 737 thousand people in December 2012, which decreased 18 thousand persons or 2.3% (Y-o-Y). The unemployment rate marked 2.9% in December, down 0.1%. Historical Data Chart

### **Labour market measures to promote growth**

Population ageing rapidly means a substantial fall in the labour force. If participation rates were to remain at their current levels for each age group,

the labour force would peak at 27.2 million in 2022 and then fall by 21%, to around 21.5 million, by mid-century. This would impose a heavy burden on workers to finance social spending. The most important strategy to mitigate demographic change would be to increase the female labour force participation rate. For women between the ages of 25 and 54, the rate was 62% in 2010, the third lowest in the OECD area. If the female participation rate in Korea were to converge to the current level for males for each age group by 2050, the labour force would only decline to around 25.6 million, almost 19% higher than in the case of unchanged participation rates. Raising the female participation rate requires a comprehensive approach such as narrowing the gender wage gap, lengthening maternity leaves, introducing more flexibility in work hours etc.

## **CONCLUSION**

South Korea is a country full of Opportunities and a rich Economic Environment. We got the privilege to research and navigate through the Macro-Economic factors that govern this country.

South Korea has been a leader in Internet connectivity, electrical appliances, ship building etc. The growth has been exponentially fast especially in 1960-80. Except for the phase during the Asian Economic Crisis, they have a constant growth rate.

Government spending has been very well regulated and Consumer Spending has been constant but has fallen with time leading to a weak Domestic Demand. Investments are high but stagnant since most of their investment go into replacing depreciated Assets.

South Korea's Exports are more than its Imports. It is one of the Top Exporters in the World. However, during slowdown in the global economy, the South Korean economy also suffers as exports form a major part of its GDP. Their Fiscal Policies were in place but Debt always existed, though always above the OECD average. They deployed Five Year Plans so as to ensure Economic Stability.

South Korea's Monetary Policy includes adoption of concepts like Inflation Targeting and Base Rate Policy to prevent Market Turmoil.

South Korea had a Fixed exchange rate, it was pegged to U. S Dollars, later it was kept floating. They have a Trade Surplus and efficient treaties and agreements as a part of their Trade Policy. Their Population is ageing, hence leading to lower Labour Force, it has been tried to counter by apt actions to maintain Productivity.

If South Korea can slightly liberalise to consumer driven economy, it will do considerably well even during global slowdowns.