Republic of Korea

Economic recovery and financial stabilization in the Republic of Korea (henceforth referred to as Korea) in 1999 were remarkable. Mitigating the adverse impacts of these changes on the fiscal position and labor market, however, is an essential challenge for stable and sustainable economic growth.

RECENT TRENDS AND PROSPECTS

After resorting to a rescue package led by the International Monetary Fund, Korea recovered at a brisk pace in 1999. Aided by ongoing financial and corporate sector restructuring and a favorable export environment, the GDP growth rate reached 10.7 percent. It stood in sharp contrast with –6.7 percent in 1998, and was the highest recorded growth since 1988.

On the production side, the manufacturing sector led the recovery of the economy. On the demand side, the rapid rebounding of private consumption and machinery and equipment investment contributed to the recovery, along with a slower pace of inventory reduction. However, construction continued to contract and net exports slowed economic growth. Owing to the economic recovery, the unemployment rate declined to 4.8 percent by December 1999, after peaking at 8.6 percent in February 1999.

Despite expansionary economic policy and rapid economic recovery, prices were extremely stable. The inflation rate dropped from 7.5 percent in 1998 to 0.8 percent in 1999, the lowest level in recent history. The appreciation of the won has significantly contributed to this price stability.

The financial conditions of the economy have improved dramatically. First, the level of foreign exchange reserves increased rapidly. In 1998 domestic demand abruptly collapsed as interest rates increased and the current account recorded a $41 billion surplus. This surplus greatly contributed to the rapid accumulation of foreign exchange reserves, from less than $10 billion at the end of 1997 to more than $74 billion at the end of 1999. As foreign exchange reserves increased, the exchange rate stabilized to around W1,150 to the dollar by December 1999.

Aided by the appreciation of the Japanese yen and the recovery in Asian markets, export performance improved in 1999. Heavy and chemical industries, particularly electronics, led the export recovery. While exports increased by 10 percent, imports grew more rapidly by 29 percent because of a recovery in domestic demand. This led to the decline in the trade account surplus from $42 billion in 1998 to $29 billion in 1999, or 7 percent of GDP.

In addition to the decline in the trade surplus, the deficit in the nontrade account, including such items as service and interest payments, widened from $1 billion in 1998 to around $4 billion in 1999. Consequently, the current account surplus decreased from $41 billion in 1998 (13 percent of GDP) to $25 billion in 1999 (6 percent of GDP). The capital account showed a surplus of $0.6 billion, despite the repayment of the International Monetary Fund emergency loan of $11 billion. Thus, there was a large net surplus in private sector inflows. Korea had net inflow for nondebt instruments such as foreign direct investment and equity investment in 1999, a likely result of the policy that pushed the large conglomerates (*chaebols*) to reduce their debt-to-equity ratios.

The government maintained the expansionary macroeconomic policies it adopted in mid-1998 to stimulate the economy. The government expenditures in 1999 were initially planned to increase by 5-6 percent from 1998, with the expectation of an overall fiscal deficit of 5 percent of GDP. Actual government expenditures increased 10 percent above the 1998 level, which had already risen by 13.5 percent from 1997. Nevertheless, the rapid recovery and growing tax revenues enabled the government to reduce the fiscal deficit to less than 3 percent of GDP.

To aid economic recovery, the central bank lowered short-term interest rates until May 1999. By then the economy had begun to gather considerable momentum and the central bank decided to halt lowering of interest rates. The call rate was kept below 5 percent for the rest of the year.

Despite the remarkable recovery in 1999, sustainable economic growth for the years to come will require significant economic restructuring, particularly in the financial and corporate sectors. Economic growth in 2000 is projected to be 7.5 percent. Fixed investment will provide the major stimulus, while the contribution of consumption and foreign trade will decline somewhat. Continued economic recovery should provide a favorable environment for business investment. In tandem with continued economic recovery, labor market conditions are expected to tighten slightly. The unemployment rate is projected to fall to 5 percent, down from 6.3 percent in 1999.

Despite strong price stability in 1999, the rapid economic recovery and increased liquidity arising from financial restructuring are likely to trigger inflationary pressure in the second half of 2000. Consequently, somewhat tighter monetary policy will be called for, and short-term interest rates are likely to be increased. However, the monetary authorities will be cautious in

Table 2.2 Major Economic Indicators, Republic of Korea, 1997-2001
(percent)

Item	1997	1998	1999	2000	2001
GDP growth	5.0	-6.7	10.7	7.5	6.0
Gross domestic investment/GDP	34.2	21.2	26.8	28.5	27.2
Gross domestic savings/GDP	32.5	33.9	33.0	30.9	27.9
Inflation rate (consumer price index)	4.5	7.5	0.8	3.2	3.2
Money supply (M2) growth	14.1	27.0	27.3	24.8	21.5
Fiscal balance/GDP	-1.5	-4.2	-2.9	-2.8	-2.6
Merchandise exports growth	6.7	-4.7	10.1	10.0	7.4
Merchandise imports growth	-2.2	-36.2	29.0	23.1	14.3
Current account balance/GDP	-1.7	12.8	6.1	2.4	0.8

Sources: National Statistical Office (1999); Bank of Korea; Korea Development Institute; Ministry of Finance and Economy; staff estimates.

raising short-term interest rates because of concern about adverse consequences of higher rates on the Daewoo crisis and on the liquidity shortages of investment trust companies. On the supply side, nominal wage growth accelerated in 1999, while domestic currency appreciation was minimal. Given these developments, consumer price inflation is projected to accelerate to 3.2 percent in 2000 and 2001.

Exports will continue to grow in 2000 as world economic growth is expected to increase in terms of both output and trade. Import prices will continue to rise more rapidly than export prices because of higher oil prices and the yen appreciation. Therefore, import growth in dollar terms will expand faster than exports and the current account surplus will shrink further.

ISSUES IN ECONOMIC MANAGEMENT

Until the outbreak of the crisis in 1997, the government had long maintained a balanced budget tradition. Operating from this foundation of fiscal prudence, the government could play a pivotal role in helping the economy recover from the crisis. In particular, the government allocated funds for financial restructuring and recapitalization, strengthened social safety nets, and boosted the economy. Because of the government's active involvement in restructuring, stability of the financial system has been restored and the economy is recovering.

The cost of this intervention has increased government debt. The central government debt was less than W50 trillion (around 11 percent of GDP) before the crisis. However, with a budget deficit of around W15 trillion for two consecutive years, government debt nearly doubled to around W94 trillion by the end of 1999. The government also will have to pay interest for W64 trillion in government-guaranteed public bonds issued to underwrite the financial sector restructuring. This will result in interest payments that will amount to 4.5 percent of the consolidated current expenditures from 1999 onward.

Faced with the explosive increase of debt burden, in January 1999 the government announced a medium-term fiscal plan for a balanced budget. According to this plan, the consolidated budget balance is expected to be restored by 2004.

However, fiscal consolidation faces many obstacles. First, the interest payment for the government's own and guaranteed debts will reach W8 trillion to W10 trillion (almost 7 percent of government expenditure) in 2001-2002. Another serious constraint is the sharp increase in the social welfare budget. In particular, the newly enacted Law for Basic Life Protection will substantially reduce the flexibility of government expenditure. This law, which will take effect in October 2000, allows any poor person to claim payments from the government, regardless of ability to work. The deficit in the pension fund for government officials will inevitably increase. According to some projections, this fund will be depleted in 2001, and the deficit will increase substantially. To minimize the subsidy for the fund, reforms need to be instituted promptly to improve the fund management and strike a balance between burden and benefit for subscribers.

Perhaps last, but not least, an important obstacle to fiscal consolidation is the laxity of fiscal discipline. As Korea went through the crisis, its balanced budget tradition was compromised, and it may be difficult to restore. Both policymakers and the public may now take having a budget deficit for granted. Therefore, achieving a strong consensus on the importance of government budget consolidation is critical.

POLICY AND DEVELOPMENT ISSUES

Unemployment, which grew substantially during the crisis, requires new policy initiatives. The unemployment rate jumped from 2.6 percent in 1997 to 6.8 percent in 1998, and peaked at 8.6 percent in February 1999. Although it slowly settled to below 5 percent by the end of 1999, the rate was still high compared with the precrisis level. This can be explained not only by macroeconomic factors such as severe postcrisis recession and massive corporate bankruptcies, but also by structural changes in the labor market.

Indeed, Korea's postcrisis reform package includes measures to improve labor market flexibility while expanding the social safety net. In particular, layoffs due to managerial prerogatives were legally instituted in the new labor law in 1998, while the unemployment insurance system was extended to cover more workers and increase the amount and duration of unemployment benefits. Improved corporate governance and strengthened risk management in the financial sector discourage reckless business expansion and tend to lower potential economic excesses. Furthermore, economic liberalization and opening up the economy will significantly enhance competition in both product and factor markets. In the short run, the move away from a lifetime employment system may exacerbate unemployment, but the long-term effects on economic efficiency and labor market flexibility should be beneficial.

The composition of unemployment changed during 1998-1999 as economic restructuring took place. Despite a continuous decline in the unemployment rate in 1999, long-term displaced workers (those jobless for more than one year) accounted for more than 15 percent of total unemployment, up from 11 percent in 1998. Unskilled production and construction workers with little education also accounted for a substantial number of displaced workers during these two years. Without effective vocational training, these workers will have difficulty re-entering the labor market. The ratio of regular workers to temporary and daily workers, however, changed from 55:45 in the first quarter of 1998 to 47:53 in the fourth quarter of 1999, indicating improved labor market flexibility.

These projections imply that increased structural unemployment must be addressed not only at the active labor policy level, but also at the institutional level. Several policy measures can ease structural unemployment.

First, labor market flexibility needs further improvement. Although layoffs were legally instituted in 1998, new and more flexible labor practices may take time to implement fully, as Korea has a long history of lifetime employment. The government should continue to reinforce market principles by strictly enforcing legal standards for disruptive labor practices, including strikes. On an institutional level, adjustable working hours can provide greater employment flexibility and reduce overtime payments. This could cut labor costs and expand employment.

Second, product market competition needs to be promoted to make the factor market more competitive. Comprehensive deregulation was pursued after the crisis by eliminating or relaxing about half of central government regulations. This should be accelerated, focusing on barriers to entry and regulations that limit price competition.

Third, labor force skills need to be enhanced. This is particularly important because growth potential should stem more from productivity growth based on knowledge than factor input expansion. To accomplish this, an improved educational system, stronger vocational training, and expanded investment in technology and innovation are needed. The budget plan for 2000 has allocated a substantially increased amount of fiscal resources for public research, development investment, and venture businesses support.

Finally, the social welfare system needs overhauling to provide an effective safety net for workers while strengthening work incentives. Both the level and duration of unemployment benefits have increased significantly since the crisis. However, they are still far less satisfactory than those of advanced Organisation for Economic Co-operation and Development member countries. Measures to strengthen work incentives for the unemployed have not kept pace with improved unemployment benefits, and the eligibility test for unemployment benefits also needs to be strengthened.