The fiscal response to the currency crisis and the challenges ahead - Korea's experience

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1. Fiscal management and its impact after the currency crisis

Fiscal position before the currency crisis

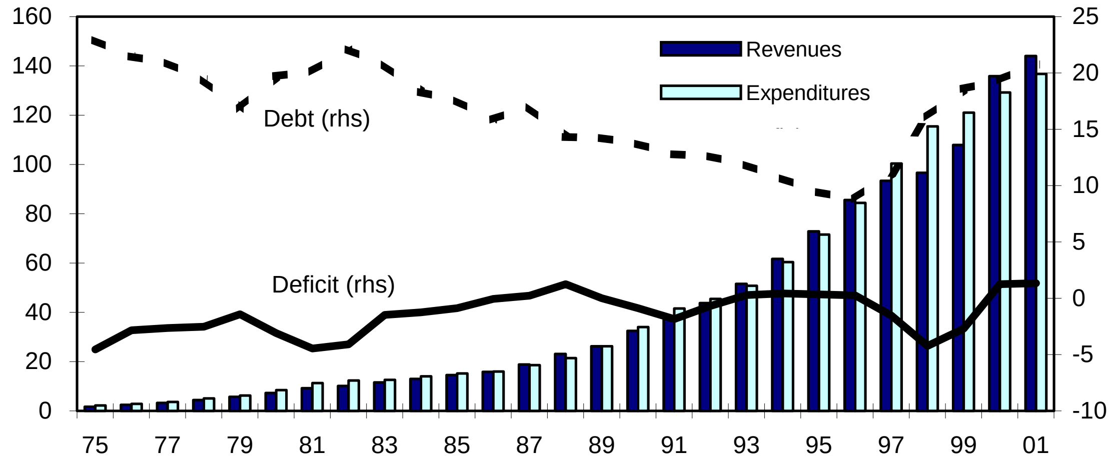
Central government expenditure was approximately 20% of gross domestic product during 1975-97. During 1975-82 it remained around 20-22% before easing to 16-19% during 1983-95, but rose again to 22% immediately before the currency crisis. Meanwhile, the scale of the consolidated public finances increased by 19.5% per annum during 1975-97.

The consolidated fiscal balance showed a chronic deficit, apart from a few exceptional periods in the latter half of the 1980s and the first half of the 1990s, because of stimulatory fiscal policies adopted in the process of economic development. In the 1970s and the first half of the 1980s, the ratio of the fiscal deficit to GDP exceeded 2%. The ratio rose above 4% immediately after the first and second oil shocks. From the early 1980s to just before the currency crisis, however, it stood at less than 2% of GDP and there were occasional fiscal surpluses. The ratio of national debt (excluding local governments) to GDP steadily declined from 23% in 1975 to 9% in 1996, immediately before the currency crisis.

Graph 1

Trends of revenues, expenditures, deficit and debt

In trillions of won (lhs) and as a percentage of GDP (rhs)



Source: Ministry of Finance and Economy.

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In conclusion, the Korean government had scope to pursue bold fiscal stimulation policies to overcome the currency crisis thanks to firm adherence to the fiscal principle of "expenditures within revenues" over a period of many years.

Major fiscal policies after currency crisis

Supporting financial restructuring

In the run-up to the currency crisis of late 1997 and in its aftermath, due to interest rate hikes and a credit crunch, a number of large corporations collapsed in chain insolvencies and the undercapitalised banks, securities companies, and some financial institutions were thrust to the brink because of a shortage of liquidity. Accordingly the financial market became extremely unstable and even the financial system itself faced the risk of collapse.

The Korean government proceeded to clean up the troubled financial institutions by the suspension of operations, purchase and assumption (P&A) and mergers etc and injected KRW 157 trillion of public funds into financial institutions through capital subscriptions, purchase of bad debts and payments of deposits of failed financial institutions. The public funds were mainly raised by issuance of Deposit Insurance Fund Bonds and Non-performing Assets Resolution Fund Bonds, whose repayment was guaranteed by the government. The government also extended interest-free loans to the Deposit Insurance Corporation and the Assets Management Corporation for interest payments on the bonds.

Table 1

Scale of public funds injected and loans for interest payments

In trillions of won

	1998	1999	2000	2001	2002 (Jan-Sept)	Total
Scale of public funds injected	55.6	35.5	37.1	27.1	1.7	157.0
Scale of government lending for interest payments	1.3	4.0	5.6	6.0	7.3	24.2

Source: Ministry of Finance and Economy.

Building a social safety net

Owing to the chain bankruptcies of firms and corporate restructuring, the unemployment rate soared to a record high level. The Korean government expanded public assistance by creating temporary jobs. It also extended the scope of social insurance to include additional beneficiaries and increased the amount of benefit available.

As compulsory membership of unemployment insurance was extended to cover workers in small corporations, and farmers and the urban self-employed were given subsidies representing some part of the contributions to encourage them to join the National Pension Scheme, the number of beneficiaries of social insurance was increased substantially. In order to stabilise the livelihood of low-income families, the scale of benefit was increased and the range of beneficiaries was also broadened. Accordingly, the related budget allocation increased by 32% per annum during 1998-2001. The government's subsidies for medical insurance covered 40% of losses by regional health insurance authorities. Along with strengthening of the social safety network, the budget for health and social security was markedly increased. The share of the budget allocation in the general account rose from 6.2% in 1997 to 10.8% in 2001 and its ratio to GDP rose from 0.9% to 2.0% during the same period.

Table 2

Number of persons receiving social insurance payments

Year-end, in millions

	1997	1998	1999	2000	2001
Unemployment	4.3	5.3	6.1	6.7	6.9
National pension	7.4	6.6	10.7	11.8	11.8
Industrial accident	8.2	7.6	7.4	9.5	10.6

Source: Ministry of Health and Welfare.

Deficit spending to counter the recession

Immediately after the currency crisis, the IMF demanded the build-up of adequate foreign reserves, stabilisation of the exchange rate, and retrenchment in financial and fiscal management. The Korean government slashed expenditure by KRW 7 trillion, which represented 10% of the original budget.

As expectations concerning economic growth worsened and the number of unemployed increased markedly, however, the government issued a revised budget whose deficit was increased to 5% of GDP in 1998 in order to cope with the surge in unemployment, support small- and medium-sized enterprises, and increase social overhead capital investment. The government continued its expansionary fiscal stance in 1999 with a fiscal deficit of 2.7% of GDP.

Fiscal conditions after the currency crisis

Consolidated expenditure

Consolidated expenditure in 2001 was KRW 136.8 trillion, which was 1.6 times the 1996 figure. Its ratio to GDP rose from 20.2% to 25.1% during the same period.

Table 3

Size of consolidated expenditures

In trillions of won and percentages

	1995	1996	1997	1998	1999	2000	2001
Scale of expenditure	71.6	84.4	100.3	115.4	121.0	129.2	136.8
Ratio to GDP	19.0	20.2	22.1	26.0	25.1	24.8	25.1

Source: Ministry of Finance and Economy.

Consolidated fiscal balance

After the currency crisis, the business cycle moved through a deep recession, a recovery phase and a renewed downturn. Reflecting this, the consolidated fiscal balance showed a similar pattern of an expanded deficit (in 1998), a reduced deficit (1999) and a shift into surplus (2000) due to the increased levels of tax revenues and contributions from social security funds that accompanied economic recovery. However, the fiscal deficit, after excluding the surplus of social security funds, represents 1.5% of GDP, which exceeds the ratio in 1996 by half a percentage point.

Table 4

Consolidated central government budget

In trillions of won and percentages

	1996	1997	1998	1999	2000	2001	2002 Jan-June
Real GDP growth rate	6.8	5.0	–6.7	10.9	9.3	3.0	6.1
Consolidated fiscal balance (A)	1.1	–7.0	–18.8	–13.1	6.5	7.3	16.1
(Ratio to nominal GDP)	0.3	–1.5	–4.2	–2.7	1.3	1.3	–
Social security funds balance (B)	5.3	5.9	6.1	7.4	12.5	15.5	9.4
Excluding social security funds (A/B)	–4.2	–2.9	–24.9	–20.5	–6.0	–8.2	6.7
(Ratio to nominal GDP)	–1.0	–2.8	–5.6	–4.2	–1.1	–1.5	–

Sources: Ministry of Finance and Economy; The Bank of Korea.

National debt

After the crisis, in order to finance the fiscal deficit and stabilise the exchange rate, the issuance of Treasury bonds and inducement of sovereign loans increased, resulting in a surge in the scale of national debt. The ratio of national debt to GDP rose from 11.9% at end-1996 to 22.4% at end-2001. Considering that net government lending also increased, fiscal soundness did not, however, deteriorate to as great an extent as may appear from the figures for the ratio of national debt to GDP.

On the other hand, contingent liabilities increased drastically after the government guaranteed the Deposit Insurance Fund Bonds and the Non-performing Asset Resolution Fund Bonds that were issued to raise the funds necessary for financial restructuring. Accordingly, the ratio of contingent liabilities to GDP rose from 1.8% at end-1996 to 19.6% at end-2001.

Table 5

Gross government debt and guarantees

In trillions of won at end-year and percentages

	1996	1997	1998	1999	2000	2001
Total debt	49.8	65.6	87.7	98.6	111.3	122.1
(Ratio to GDP)	11.9	14.5	19.7	20.4	21.4	22.4
Government guarantees	7.6	13.0	72.0	81.5	74.6	106.8
(Ratio to GDP)	1.8	2.9	16.2	16.9	14.3	19.6
Total debt plus government guarantees	57.4	78.6	159.7	180.1	185.9	228.9
(Ratio to GDP)	13.7	17.4	35.9	37.3	35.7	42.0

Source: Ministry of Finance and Economy.

Expenditure structure

As the share of fixed or mandatory expenditures, such as social security expenditures for guaranteeing a minimum livelihood and debt servicing expenses, increased, the share of the budget which the government could allocate at its discretion correspondingly shrank. Of the total budget (in terms of general account and net lending), the share of such fixed expenditure[2] rose from 54.4% in 1997 to 59.3% in 2002. Correspondingly the scope for discretionary spending narrowed from 45.6% to 40.7% over the same period.

Table 6

Share of fixed expenditures

In trillions of won and percentages

	1997	1998	1999	2000	2001	2002	Increase 1997-2002 in %
Fixed expenditures (A)	38.7	42.5	46.0	51.7	63.8	66.4	72
General account and net lending (B)	71.2	80.8	88.5	94.9	106.1	119.8	68
A/B	54.4	52.7	52.0	54.7	60.1	59.3	

Source: Ministry of Finance and Economy.

2. Evaluation of fiscal policy's stabilising role after the crisis

Before the crisis, the government adhered to its self-imposed principle of "expenditures within revenues". Therefore, there was little room for conducting fiscally based countercyclical stabilisation policies. Immediately after the crisis, the government implemented bold fiscal policies to curb unemployment and boost the economy, which resulted in the expansion of national debt. In order to prevent the consolidation of the trend of fiscal deficits, the government focused on fiscal soundness. Therefore it has come to rely more on control of the rate of budget disbursement to lean against the wind in smoothing the movement of the business cycle since 2000.

In conducting monetary policy, The Bank of Korea closely monitors the fiscal stance and position using various fiscal indicators such as the consolidated fiscal balance, the rate of increase of expenditures, the rate of budget disbursement, the fiscal impulse indicator and the structural fiscal balance.

The role of automatic fiscal stabilisers has been relatively small in that the scale of the public finance, representing 25% of GDP, was far below that of most OECD members. It has shown an increasing trend, reflecting the larger share of public finance and strengthened social safety net.

As for discretionary fiscal policy, the Korean government has been generally successful in smoothing the business cycle, ensuring stable economic growth. During the period 1997-99, an especially hard time for the Korean economy, the government aggressively boosted the depressed economy by fiscal pump priming. Since 2000, it has been placing more stress on fiscal soundness, the capacity for repayment of public funds and a balanced budget, while less stress has been put on the dynamic use of fiscal policy.

[2] Generally fixed expenditure means spending that is mandated by law or government commitment. In Korea, however, the defence budget and transfers to local governments are classed as non-discretionary spending because the tensions between South and North Korea make the defence budget very inflexible and transfers to local governments are stipulated by legislation.

Table 7

Decomposition of consolidated fiscal balance

	Fiscal balance (trillions of won)			D = A/GDP (%)	E = B/potential GDP (%)	F = D – E (%)	GDP gap (%)	Elasticity of fiscal balance to GDP	Fiscal stance
	Consolidated (A)	Structural (B)	Cyclical (C)						
1995	1.2	–2.4	3.6	0.33	–0.66	0.99	5.3	0.19	–0.69
1996	1.1	–3.4	4.5	0.26	–0.86	1.13	5.5	0.21	–0.20
1997	–7.0	–10.5	3.5	–1.54	–2.40	0.86	3.7	0.23	–1.53
1998	–18.8	–10.1	–8.7	–4.22	–2.05	–2.17	–9.5	0.23	0.35
1999	–13.1	–8.3	–4.8	–2.71	–1.66	–1.05	–3.9	0.27	0.39
2000	6.5	8.1	–1.6	1.25	1.55	–0.30	–0.8	0.36	3.20
2001	7.3	9.2	–1.9	1.34	1.66	–0.32	–1.4	0.23	0.12
2002e	12.9	13.7	–0.8	2.20	2.32	–0.12	–0.4	0.32	0.66

Source: Korea Institute of Public Finance.

3. Challenges to fiscal policy

Although Korea’s ratio of national debt to GDP is relatively low compared to other OECD countries, more efforts need to be made to enhance fiscal soundness. This is because of the numerous factors acting to induce a deficit: government should absorb the loss of KRW 49 billion of public funds injected to clean up the financial sector; in the long run, the National Pension Fund is expected to slide into deficit; and the expenditures associated with Korean reunification will also escalate continually.

Even though the consolidated fiscal balance has recorded a surplus since 2000, the national debt/GDP ratio shows an increasing trend when we strip out the surplus from social security funds such as the National Pension Scheme. Accordingly, strong measures to augment fiscal soundness are called for, such as expenditure controls or reduction of tax exemptions. At the same time as maintaining fiscal soundness, the role of fiscal policy in stabilisation should also be strengthened, which requires the following institutional changes or improvements.

So far the stabilising role of fiscal policy has been constrained by the “expenditures within revenues” principle. A medium-term fiscal plan should be drawn up and followed to allow government to pursue stabilisation policy from a medium- and long-term perspective.

In order to heighten the transparency of fiscal policy and strengthen fiscal discipline, government should be made more accountable for achieving the objectives of fiscal policy, and the principles for the execution of fiscal policy.