Chapter 2

Macroeconomic policy: the exit from fiscal and monetary stimulus

Korea's strong recovery from the global financial crisis stems in part from an effective macroeconomic policy response. The prompt withdrawal of fiscal stimulus in 2010 will help meet the medium-term fiscal plan for reducing budget deficits. Given the increase in government spending in the past, making the targets in the plan more binding is important to help achieve the fiscal target. In addition, the broadening of tax bases would be beneficial in this regard. While such policies would help limit government debt, it is also necessary to contain the rapidly rising debt of public corporations, in part by further progress in the 2008 privatisation programme. Monetary stimulus has also supported the recovery. Given the expected strength of output growth in 2010, it is important that the Bank of Korea not fall behind the curve in withdrawing monetary stimulus. Korea should continue its flexible exchange rate policy.

Given the strong economic recovery, thanks in part to effective fiscal and monetary stimulus, the appropriate timing and pace of an exit strategy is a more urgent question in Korea than in most other OECD countries. On the fiscal side, Korea's legacy of sound spending and tax policies has kept the government in a strong financial position. Nevertheless, the pressures related to rapid population ageing, as well as the potential cost of economic integration with North Korea, make fiscal consolidation a priority. As for monetary policy, the Bank of Korea has kept the policy interest rate at a record low 2% since early 2009, while inflation has fallen back within the target zone in the wake of the crisis. Given uncertainty about the world economic outlook, the Bank has been cautious about withdrawing monetary policy stimulus. However, waiting too long to start normalising interest rates would have adverse consequences for consumer and asset price stability. This chapter considers the appropriate fiscal and monetary policies in an uncertain economic environment. Recommendations are summarised in Box 2.3 in the concluding section.

Fiscal policy

The large and prompt fiscal response to the crisis is being scaled back in 2010

The government responded to the sharp economic downturn resulting from the global financial crisis with a fiscal stimulus package of 6.1% of GDP, the largest among the 26 OECD countries adopting explicit crisis-driven stimulus programmes (Table 2.1). Moreover, the stimulus was implemented in a timely manner. Additional expenditure was included in a September 2008 supplementary budget and in the 2009 budget, along with temporary tax cuts. Another supplementary budget followed in April 2009. In addition,

Table 2.1. **Composition of fiscal packages in the major countries**[1]

Announced or implemented over the period 2008-10 as a share of 2008 GDP

	Net effect	Tax measures					Spending measures					
		Total	Individuals	Firms	Consumption	Social contributions	Total	Final consumption	Investment	Transfers to households	Transfers to firms	Transfers to sub-national government
Canada	–4.1	–2.4	–0.8	–0.3	–1.1	–0.1	1.7	0.1	1.3	0.3	0.1	. .
France	–0.7	–0.2	–0.1	–0.1	0.0	0.0	0.6	0.0	0.2	0.3	0.0	0.0
Germany	–3.2	–1.6	–0.6	–0.3	0.0	–0.7	1.6	0.0	0.8	0.3	0.3	0.0
Italy	0.0	0.3	0.0	0.0	0.1	0.0	0.3	0.3	0.0	0.2	0.1	0.0
Japan	–4.7	–0.5	–0.1	–0.1	–0.1	–0.2	4.2	0.2	1.2	0.6	1.5	0.6
Korea	**–6.1**	**–2.8**	**–1.4**	**–1.1**	**–0.2**	**0.0**	**3.2**	**0.0**	**1.2**	**0.7**	**1.0**	**0.3**
United Kingdom	–1.9	–1.5	–0.5	–0.2	–0.6	0.0	0.4	0.0	0.4	0.2	0.0	0.0
United States	–5.6	–3.2	–2.4	–0.8	0.0	0.0	2.4	0.7	0.3	0.5	0.0	0.9
OECD average[2]	**–3.9**	**–1.9**	. .	. .	. .	. .	**–2.1**	. .	. .	. .	. .	. .

1. The amounts shown in the total columns do not always match the sum of the columns shown because some components either have not been clearly specified or are not classified in this breakdown.
2. Weighted average of countries that adopted positive stimulus programmes.
Source: OECD (2009), *OECD Economic Outlook*, No. 85, OECD, Paris.

personal and corporate income tax rates were permanently cut in 2009-10. Korea's legacy of fiscal soundness, which had contained government spending and debt at relatively low levels, gave the authorities ample room for manoeuvre to respond to the crisis.

The stimulus is almost evenly divided between additional expenditure (3.2% of GDP) and tax cuts (2.8%). On the spending side (Table 2.2), additional public investment (1.2% of GDP) was driven in part by the "Green New Deal Policy" announced in January 2009, which included major infrastructure projects, notably the Four Major Rivers Restoration Project and railroad construction (Chapter 5). Such projects were a key factor boosting short-term public employment by 276 thousand in 2009, thereby limiting the rise in unemployment and supporting private consumption (Chapter 1). In addition, transfers to local governments also financed such jobs. Short-term public employment in 2010 is slated to remain well above its 2008 level. A second major spending category was transfers to businesses (1% of GDP), particularly small and medium-sized enterprises (SMEs). There were also large transfers to public financial institutions to cope with financial-sector problems and provide more lending to SMEs (Chapter 3).

Table 2.2. **Fiscal stimulus in Korea**

Announced or implemented over the period 2008-10 as a share of 2008 GDP

Spending measures	Per cent of 2008 GDP	Tax cuts	Per cent of 2008 GDP
Total[1]	**3.2**	**Total**	**2.8**
Public investment	1.2	For individuals	1.4
Transport	0.4	Targeted on low-income groups	0.6
Energy	0.2	Increased personal tax allowance	0.1
Other[2]	0.6	Oil tax rebate	0.5
		Reductions in housing-related taxes	0.4
		Personal income tax cut	0.3
Transfers to households	0.7	For businesses	1.1
Pensions	0.3	Tax relief associated with new spending:	0.4
Unemployment benefits	0.2	R&D	0.1
Lengthening benefit duration	0.1	Investment	0.3
Loosening eligibility criteria	0.2	Corporate income tax cut	0.7
Other income-related transfers	0.1		
Transfers to businesses	1.0	On consumption	0.2
Small and medium-sized enterprises	0.4	Cuts in general consumption taxes	0.1
For public financial institutions	0.3	Cuts in car-related taxes	0.1
To job-creating companies	0.2		
Construction and transport sectors	0.1		
Other	0.1	Other	0.2
Transfers to sub-national governments	0.3		

1. The government increased spending in FY 2008 through a supplementary budget of 4.6 trillion won passed in September 2008. For FY 2009, spending was boosted by 11.4 trillion won in December 2008 and by a supplementary budget of 17.2 trillion won that was passed in April 2009.
2. Includes 0.1% of GDP each for agriculture, education, public services, environment protection, defence and housing and health.

Source: OECD Secretariat.

On the tax side (Table 2.2), about half of the cuts were targeted on households. Most of the tax reductions were temporary measures for low-income households and cuts in housing-related taxes. On the business side, tax reductions were aimed at boosting R&D and investment. Finally, consumption taxes were lowered, including those on cars, thus helping to boost car sales in Korea by 20% in 2009. In addition to these temporary measures, there were permanent cuts in income tax rates:

- The three lower personal income tax rates were reduced in 2009-10 by 2 percentage points from a range of 8-26% to 6-24%. The cut in the top rate of 35% was delayed until 2012.
- The corporate income tax rate (national and local) was cut from 25% to 22% in 2009, pushing it well below the OECD average of 28%. The planned reduction to 20% was delayed until 2012.
- The corporate income tax rate for SMEs was reduced from 11% in 2008 to 10% in 2010.

The discretionary fiscal measures, coupled with cyclical revenue losses, had a significant impact on the fiscal balance in 2008 and 2009 (Table 2.3). The additional outlays in 2008 expanded the deficit in the consolidated central government budget (excluding the social security surplus) from a projected 1.1% of GDP to 1.5%.[1] With the stimulus packages, government spending in 2009 increased by 14.3%, while tax revenue as a share of GDP fell by another ½ percentage point as a result of weak economic growth and tax cuts. Consequently, the deficit widened further in 2009 to 4.1% of GDP, the largest since 1998.

The government scaled back fiscal stimulus in the 2010 budget by cutting spending by 4.2% relative to 2009 (including the supplementary budget).[2] Such a large fall in outlays will reduce their share of GDP to the 2008 level. Even with tax revenue growth limited by rate cuts, the budget deficit (excluding the social security surplus) is projected to fall

Table 2.3. **Consolidated central government budget**[1]

	2006	2007	2008		2009		2010
	Outcome[2]	Outcome[2]	Initial budget[3]	Outcome[2]	Initial budget[3, 4]	Outcome[2]	Initial budget[3]
A. Total							
Revenue	209.6	243.6	247.2	250.7	253.9	255.3	262.3
Growth (per cent)	9.5	16.2	9.8	2.9	2.7	1.8	3.3
Per cent of GDP	23.1	25.0	24.1	24.5	24.0	24.0	23.2
Expenditures	205.9	209.8	230.2	238.8	275.9	272.9	264.3
Growth (per cent)	9.6	1.9	8.1	13.8	19.9	14.3	–4.2
Per cent of GDP	22.7	21.5	22.5	23.3	26.0	25.7	23.4
Balance	3.6	33.8	17.0	11.9	–22.0	–17.6	–2.0
Per cent of GDP	0.4	3.5	1.7	1.2	–2.1	–1.7	–0.2
of which:							
Social security balance	26.4	30.2	28.1	27.5	29.1	25.6	28.1
Per cent of GDP	2.9	3.1	2.7	2.7	2.7	2.4	2.5
Privatisation revenues	0.7	0.0	1.0	0.0	0.0	0.0	0.7
Per cent of GDP	0.1	0.0	0.1	0.0	0.0	0.0	0.1
Financial-sector restructuring costs	12.0	0.0	0.0	0.0	0.0	0.0	0.0
Per cent of GDP	1.3	0.0	0.0	0.0	0.0	0.0	0.0
B. Alternative measures of the balance							
Excluding social security	–22.8	3.6	–11.1	–15.6	–51.0	–43.2	–30.1
Per cent of GDP	**–2.5**	**0.4**	**–1.1**	**–1.5**	**–4.8**	**–4.1**	**–2.7**
Excluding social security, privatisation and financial-sector restructuring costs	–11.5	3.6	–12.0	–15.6	–51.0	–43.2	–30.8
Per cent of GDP	–1.3	0.4	–1.2	–1.5	–4.8	–4.1	–2.7

1. In trillion of won unless specified otherwise, and on a GFS basis.
2. Growth rate is relative to previous year's outcome.
3. Growth rate is relative to previous year's initial budget.
4. Including the April 2009 supplementary budget.

Source: Ministry of Strategy and Finance.

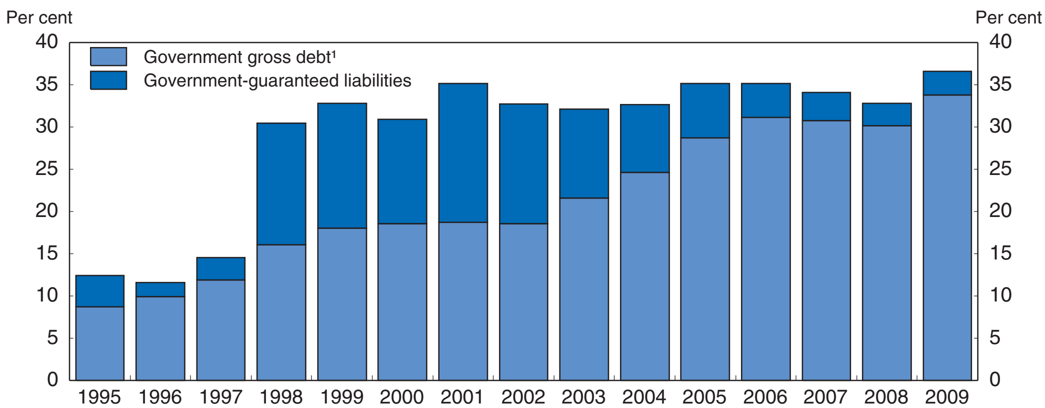
to 2.7% of GDP in 2010. To reduce spending, the government eliminated some of the projects funded by the stimulus packages that appeared to be less effective. The largest cut by spending category in 2010 is a 30.8% fall in industry, SMEs and energy, where much of the fiscal stimulus had been concentrated. Significant spending reductions are also planned for the environment (5.3%), general public administration (4.1%) and education (3.6%). This will be partially offset by a 7.1% rise in R&D spending, in line with the mid-term plan to boost public R&D by 50% between 2008 and 2012. The investment will be concentrated in basic science, new growth engines and green technologies (MOSF, 2009).

The impact on public debt

Gross government debt was 32% of GDP in 2008 (general government basis) in Korea, the sixth lowest in the OECD area and well below the OECD average of 79%. Nevertheless, the ratio had tripled from less than 10% in 1996, primarily due to the 1997 crisis (Figure 2.1). Indeed, gross debt jumped to 16% in 1998, with an almost equivalent amount of government-guaranteed debt, which was issued by public institutions and used to restructure the financial system by re-capitalising financial institutions and purchasing non-performing assets (Chapter 3). The sum of government debt and government-guaranteed debt remained stable at between 30% and 35% of GDP during the decade from 1998. However, the composition changed as 49 trillion won of government-guaranteed debt was replaced by government debt between 2003 and 2006.

Figure 2.1. **Government gross debt and guaranteed liabilities**

Per cent of GDP



1. On a GFS basis including local government debt.

Source: Ministry of Strategy and Finance.

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Gross government debt reached a record high of 34% of GDP in 2009 (Figure 2.1), although the four percentage-point increase was relatively small compared to the average of 11 points in the OECD area.[3] Moreover, the rise in the debt ratio in Korea in 2009 was relatively modest compared with its 1996-98 experience. In addition, this time Korea avoided a sharp expansion in government-guaranteed debt, as the need for public money for financial restructuring was much smaller (Chapter 3). The medium-term fiscal plan (see below) shows the debt ratio peaking at 37.6% of GDP in 2011 before falling back to 35.9% in 2013.

However, the debt of Korea's 24 public corporations – which is not included in government debt – more than doubled from 84 trillion won in 2004 to 177 trillion won in 2008, boosting its share of GDP from 10.2% to 17.2% (Table 2.4). The list of public corporations includes major enterprises, such as the Korea Land and Housing Corporation, the Korea Expressway Corporation and the Korea Electric Power Corporation. Rising debt boosted public corporations' debt-to-capital ratio from 85% in 2004 to 133% in 2008. Public corporations have become saddled with increasing amounts of debt over the years in part because they have been mobilised to undertake a number of infrastructure development projects. For example, the Korea Water Resources Corporation planned to spend 8 trillion won (0.8%) of GDP between 2009 and 2012 on the Four Major Rivers Restoration Project (Chapter 5) and 2 trillion won between 2009 and 2011 to build a canal linking Seoul and Incheon. In addition, some public corporations have provided overly generous compensation packages to their executives.

Table 2.4. **The debt and assets of public corporations and agencies**[1]

Trillion won and per cent of GDP

	2004	2005	2006	2007	2008	Annual growth (%)
Debt of public corporations and agencies						
In trillion won	241	248	254	276	321	7.4
Per cent of GDP	29.1	28.7	28.0	28.3	31.3	
Debt of public corporations						
In trillion won	84	99	119	138	177	20.6
Per cent of GDP	10.2	11.4	13.1	14.2	17.2	
Debt of public agencies						
In trillion won	157	149	135	138	144	–2.3
Per cent of GDP	19.0	17.2	14.9	14.2	14.0	
Assets of public corporations and agencies						
In trillion won	355	416	455	491	532	10.6
Per cent of GDP	42.9	48.1	50.1	50.4	51.8	
Assets of public corporations						
In trillion won	182	215	241	267	310	14.2
Per cent of GDP	22.0	24.8	26.5	27.4	30.2	
Assets of public agencies						
In trillion won	173	201	214	224	222	6.5
Per cent of GDP	20.9	23.2	23.5	23.0	21.6	
Debt/capital (in %) for public corporations and agencies	212	149	126	128	152	
Debt/capital (%) for public corporations	85	86	98	107	133	
Memorandum items:						
General government debt[2]						
In trillion won	177.1	231.8	273.5	296.1	331.0	16.9
Per cent of GDP	21.4	26.8	30.1	30.4	32.2	
General government assets[3]						
In trillion won	412.1	483.2	544.6	617.9	643.0	11.8
Per cent of GDP	49.8	55.8	59.9	63.4	62.6	

1. Includes 270 public agencies and 24 public corporations, which are defined as public entities that generate more than half of their revenue themselves. Three publicly-owned banks are excluded.
2. Does not include the debt of public corporations and agencies. These figures are derived on the basis of SNA93.
3. Does not include the assets of public corporations and agencies. These figures are derived on the basis of SNA93.

Source: Ministry of Strategy and Finance and OECD.

The rising debt of public corporations has been partially offset by a decline in the debt of 270 public agencies since 2004. Nevertheless, the combined debt of public corporations and public agencies reached 31.3% of GDP in 2008.

Appropriate corporate governance of public enterprises is a major challenge in many countries, given that such enterprises are protected from bankruptcy and takeover, two major threats that discipline the management of private firms. The OECD's "Guidelines on Corporate Governance of State-Owned Enterprises" presents a number of principles that would improve the performance of public corporations (OECD, 2005). *First*, the government should not automatically guarantee public corporations' liabilities, as doing so may shelter them from a crucial source of market monitoring and pressure, thereby distorting their incentive structure. Automatic guarantees tend to encourage excessive indebtedness, wasted resources and market distortions, to the detriment of both creditors and taxpayers. *Second,* it is important to observe high standards of transparency by making public corporations subject to the same level of accounting and auditing standards as listed companies, thus requiring them to disclose financial and non-financial information. *Third,* the government should not be involved in the day-to-day management of public corporations. Instead, it should allow them full operational autonomy to achieve their defined objectives and recognise the independence of their boards. In the case of Korea, public corporations should not take on public infrastructure projects that exceed their ability to generate revenue, thus forcing them to rely excessively on debt. Moreover, the five-year financial management plans of public corporations should be subject to increased oversight by the National Assembly.

Although Korea sold eight important public enterprises in the wake of the 1997 crisis, privatisation stalled after 2002. The government announced a plan in October 2008 to privatise 24 state-owned institutions, including the Korea Development Bank and the Industrial Bank of Korea. However, the major network industries, such as electricity, gas and water companies, were not included in the plan. By March 2010, six of the designated institutions had been privatised.[4] The 2008 plan also called for streamlining the other public institutions. By March 2010, 36 institutions had been merged into 16.[5] In addition, 129 institutions were restructured to improve efficiency, reducing employment by 22 thousand, a 12.7% decline.

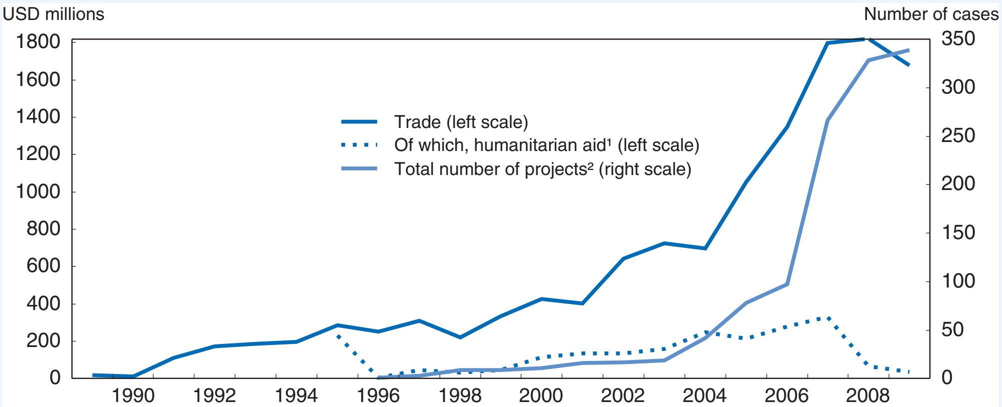
Korea's medium-term fiscal plan

Maintaining a sound fiscal position in Korea is a priority given spending pressures, including those stemming from population ageing (Chapter 3) and the potential cost of intensified economic co-operation with North Korea (Box 2.1). In 2004, Korea implemented a series of fiscal reforms to enhance the efficiency of public spending. The most important measure was the introduction of the National Fiscal Management Plan, which aimed at controlling fiscal risk and facilitating efficient resource allocation by integrating a medium-term perspective into budgeting.[6] The plan serves as a baseline for the fiscal balance and the sectoral allocation of expenditure. In the past, budget formulation focused on a single year, resulting in weak prioritisation of resources. Since 2007, the government is required to submit the medium-term fiscal plan to the National Assembly, even though the plan is not legally binding. The plan is presented to the legislature each October, along with the budget for the following fiscal year.[7]

Box 2.1. **Economic co-operation with North Korea**

North-South trade fell by 8% in 2009, the first decline since 2004 (Figure 2.2), and is only 0.2% as large as the South's international trade. Nevertheless, the South remained the North's top export destination at USD 932.3 million, ahead of China at (USD 793 million), thanks to a rapid expansion of trade related to economic co-operation projects.[1] Economic factors have increasingly driven North-South exchanges, even though political factors remain an obstacle.[2]

Figure 2.2. **Inter-Korean economic relations**



1. Includes both public and private assistance, primarily for food.
2. The cumulative number of approved private economic co-operation projects including those in the Gaesong Industrial Complex.

Source: Ministry of Unification.

StatLink http://dx.doi.org/10.1787/888932302587

The Mt. Geumgang resort, which was built in the late 1990s by a South Korean company with government subsidies, was suspended after a South Korean tourist was killed near the resort in July 2008. While the North has requested a resumption of the project, the South demanded three prerequisites: *i)* a joint investigation of the 2008 incident; *ii)* safeguards to prevent a similar incident; and *iii)* the creation of institutions to guarantee security. The North recently froze private South Korean assets at Geumgang and confiscated five South Korean government-run facilities there, threatening to resume the tours with a new business partner. In addition to the problems in government-initiated ventures, private-sector economic co-operation, which had tripled in terms of the number of approved projects between 2006 and 2008, has stalled (Figure 2.2).

In the wake of the sinking of a South Korean vessel, President Lee suspended trade and investment with the North in May 2010, although the Gaesong Industrial Complex, which was established in 2004 as a site for South Korean SMEs, will continue to operate. It now accounts for more than 55% of inter-Korean trade, as Gaesong-related trade increased by 16% in 2009 despite unfavourable political factors.[3] The growing importance of Gaesong reflects its success in combining the capital and technology of the South with land and labour in the North. For SMEs, Gaesong, located 60 kilometres north of Seoul, offers a solution to high wages and labour shortages in the South. Infrastructure, including rail and road links, electricity and communications, is provided by the South Korean government and the firms involved, while a public financial institution provides low-interest loans and insurance. North Korean workers employed in Gaesong are paid an average of USD 82.6 per month,[4] less than 5% of the average manufacturing wage in South Korea. As of February 2010, the complex contained 118 factories employing about 43 400 North Korean workers and 930 South Koreans. However, the North has been demanding wage hikes and higher land-use fees since 2009, creating an uncertain atmosphere for business. Moreover, the North recently has indicated that it would look for new business partners.

Box 2.1. **Economic co-operation with North Korea** *(cont.)*

Following two years of contraction, the North Korean economy is estimated to have grown by 3.7% in 2008. However, currency reform in November 2009 triggered severe economic problems. The South Korean economy is now about 38 times larger than the North's and 18 times larger on a per capita basis (Table 2.5). The long-term decline of the North is illustrated by the latest population census, which reported that the infant mortality rate increased from 14.1 in 1993 to 19.3 per 1 000 in 2008, compared to 4.1 in the South. Moreover, average life expectancy has dropped by 3 years, to 69.3, for women.[5] The large gap in income and health will boost the eventual cost of economic integration, although some argue that the large scope for convergence will promote high growth in the South (Kwon, 2009). The expansion of trade driven by private-sector firms in the South, in line with the government's strategy of limiting co-operation to projects that are economically viable and that do not overburden taxpayers in the South, provides the best hope for limiting the gap.

Table 2.5. **Comparison of North and South Korea in 2008**

	(A) North Korea	(B) South Korea	(A/B) Comparison (%)
Population (millions)	23.3	48.6	47.9
GDP (billion USD)	24.7	928.7	2.7
GDP per capita (USD)	1 060.5	19 105.6	5.6
Total trade (billion USD)	3.8	857.3	0.4
Exports	1.1	422.0	0.3
Imports	2.7	435.3	0.6
Inter-Korean exports (million USD)	932.3	888.1	105.0
Commercial exports[1]	931.0	768.8	121.1
Non-commercial exports[2]	1.3	119.3	1.1
Industrial statistics			
Power generation (billion kWh)	255.0	4 224.0	6.0
Steel production (million tonnes)	1.3	53.3	2.4
Cement production (million tonnes)	6.4	51.7	12.4
Agricultural production			
Grains (million tonnes)	4.3	5.5	78.3
Fertilizer (million tonnes)	0.5	3.2	15.0

1. Economic co-operation projects account for more than half of commercial trade.
2. Mostly includes humanitarian aid in the form of commodities such as rice and fertiliser.

Source: Bank of Korea and Ministry of Unification.

1. Inter-Korean trade is divided into commercial and non-commercial (including aid). Commercial trade is classified into general trade, processing-on-commission trade and economic co-operation projects. The composition of trade varies between the different classifications. Traditional commodities, such as agricultural products, are predominant in general trade, while textiles and electric and electronic products are the main items in the other categories.
2. For example, the North unilaterally suspended land routes from the South on 9 and 13 March 2009.
3. In particular, the North limited access to and the stay of South Korean workers in Gaesong in December 2008 and detained some South Korean employees. These problems were later resolved after bilateral talks.
4. In addition to wages, there is a social insurance contribution that averaged USD 9.20 per employee in December 2009.
5. The 2008 population census was conducted by the Central Bureau of Statistics of North Korea in collaboration with the United Nations Population Fund.

The medium-term plan was accompanied by the introduction of top-down budgeting. Under this approach, the Cabinet meets in May, before the line ministries submit their spending proposals, to discuss the economic outlook, fiscal targets and policy priorities. Building a consensus on fiscal policy and resource allocation at an early stage of the budget process was not possible under the bottom-up approach of the past. Once sectoral and ministerial spending ceilings are determined by the Cabinet, each line ministry is allowed to autonomously formulate their respective budgets, thereby increasing efficiency. In addition, the government fully reviews all budget programmes and projects using a zero-base approach.

The 2004 medium-term plan projected that spending would rise at a 6.3% annual average rate through 2008, increasing it from 23.7% of GDP to 24.4%.[8] In the event, expenditure rose at a 7.0% rate, increasing its GDP share to 25.1%. The consolidated central government budget, excluding the social security surplus, recorded a deficit of 1.5% of GDP in 2008 rather than the balance shown in the 2004 medium-term plan (Table 2.6). The extra 0.7% of GDP in spending in 2008 (from 24.4% to 25.1%) thus explained about one-half of the budget deficit.

Table 2.6. **The budget balance in the National Fiscal Management Plan**[1]

Per cent of GDP

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
2004 plan	–0.9	–1.0	–0.6	–0.3	0.0					
2005 plan		–1.5	–1.3	–1.1	–1.0	–0.9				
2006 plan			–1.7	–1.5	–1.2	–1.0	–0.8			
2007 plan				–1.6	–1.1	–1.0	–0.9	–0.6		
2008 plan					–1.1	–1.0	–0.9	–0.5	0.0	
2009 plan						–5.0	–2.7	–2.3	–1.3	–0.5
Outcome	–0.6	–1.0	–1.3	0.4	–1.5	–4.1				

1. The balance of the consolidated central government budget, excluding the social security surplus and the cost of financial-sector restructuring.

Source: Ministry of Strategy and Finance.

Fiscal stimulus lifted government spending further to 28.4% of GDP in 2009, while the revenue share has fallen in the wake of the crisis. As a result, the 2008 medium-term fiscal plan's target of a budget balance by 2012 is no longer realistic. Accordingly, the 2009 plan included a less ambitious target of a 1.3% of GDP deficit in 2012, falling to 0.5% in 2013 (Table 2.7). Meeting these targets will still be challenging, given that the government expects that the cuts in income tax rates will reduce revenue by 1% of GDP. Narrowing the deficit from the expected 2.7% of GDP in 2010 (Table 2.3) to 0.5% by 2013 would require limiting the annual growth of government spending to around 4%, a significant slowdown from the 7% rate between 2004 and 2008.

The completion of many of the stimulus projects included in the 2008-09 budgets will make it easier to achieve the spending targets for 2013. The introduction of new projects is conditional on self-financing or resources made available from savings on other projects. There are a number of other measures to encourage spending discipline: *i)* the objectives of preliminary feasibility studies for large-scale projects will be expanded and the assessment criteria will be strengthened to avoid wasteful spending; *ii)* the government will urge the National Assembly to require committees to consult with the Special Committee on Budget

Table 2.7. **The 2009 National Fiscal Management Plan for 2009-13**

Trillion won unless noted otherwise[1]

	2009		2010[2]	2011	2012	2013
	Original budget	Including the supplementary budget				
2009 plan						
GDP growth rate (in per cent)	4.0	–2.0	4.0	5.0	5.0	5.0
Revenue (A)	291.0	279.8	287.8	309.5	337.6	361.7
Expenditure (B)	284.5	301.8	291.8	306.6	322.0	335.3
Balance	6.5	–22.0	–4.0	2.9	15.6	26.4
Per cent of GDP	0.6	–2.1	–0.4	0.2	1.2	1.9
Balance excluding social security	–24.8	–51.0	–32.0	–27.5	–16.1	–6.2
Per cent of GDP (C)	–2.4	–5.0	–2.9	–2.3	–1.3	–0.5
Government debt (as per cent of GDP)	34.1	35.6	36.9	37.6	37.2	35.9
2008 plan						
Revenue (D)	–	295.0	314.7	339.2	367.0	–
Expenditure (E)	–	273.8	290.9	308.7	326.7	–
Balance excluding social security	–	–10.4	–9.7	–6.6	0.0	
Per cent of GDP (F)	–	–1.0	–0.9	–0.5	0.0	–
Difference between the plans						
Revenue (A – D)	–	–10.2	–26.9	–29.7	–29.4	–
Expenditure (B – E)	–	28.0	0.9	–2.1	–4.7	–
Balance (C – F)	–	–4.0	–2.0	–1.8	–1.3	

1. The numbers differ from Table 2.3, which includes government net lending in spending. In this table, government gross lending is included in spending while the repayment of government loans is shown in revenues, thereby boosting reported spending.
2. The final budget approved by the National Assembly included revenue of 290.8 trillion won, expenditure of 292.8 trillion won and a budget balance (excluding the social security surplus) of 2½ per cent of GDP.

Source: Ministry of Strategy and Finance.

and Accounts before passing budget-related bills; *iii)* upgrading performance evaluation systems will allow their greater use in the budget formulation process; and *iv)* the accrual accounting system will be applied to government accounts from 2012.

In April 2010, the government amended the National Finance Act to improve the effectiveness and comprehensiveness of the medium-term fiscal plan. *First*, the government has to submit to the National Assembly the evaluation and analysis reports of the previous year's medium-term plan, the Government Debt Management Plan, the Government Guaranteed Liability Management Plan, and the Mid- and Long-Term Plan of Public Funds Management. *Second*, the plan should include more information on the economic assumptions, including their impact on revenues, underlying the target for the consolidated budget balance. *Third*, the plan will classify spending into mandatory and discretionary expenditures. *Fourth*, when supplementary budgets or revisions to annual budgets are submitted to the National Assembly, they will have to include a report on its impact on the medium-term plan. *Fifth*, the medium-term plan will be submitted to the relevant standing committee in the National Assembly for review before it is formally submitted to the National Assembly in October of each year.

While these reforms are likely to make the plan more effective, they should be accompanied by steps to make the medium-term fiscal plan more binding on the government. Empirical evidence suggests that a combination of budget balance and spending rules produces the best results for fiscal consolidation (Guichard *et al.*, 2007).

While simple budget balance rules are inherently pro-cyclical, spending rules work best during economic upturns due to their counter-cyclical nature. Violations of a spending rule are generally more transparent and incontrovertible, thus promoting compliance (Anderson and Minarik, 2006). Almost all OECD countries have budget balance targets and 11 also have spending targets. In nearly three-quarters of member countries, a medium-term budget framework must be presented to the legislature. However, in most countries, including Korea, there is no legal obligation for the medium-term fiscal plan to be formally approved by the legislature (Lienert and Jung, 2004). The key to an effective medium-term fiscal plan is its power to bind annual budgets to the outcomes contained in the plan in order to achieve the fiscal target.

As noted above, Korea's medium-term plan contains targets for both the budget balance and the level of spending. However, the plan has no legally binding power on annual budgeting. Given that credibility and accountability are critically important to the success of a medium-term framework, Korea needs to establish fiscal rules by law or by a Cabinet decision. Furthermore, consensus building and communication of the fiscal plan across the government is vital for its credibility, requiring strong commitment at the very top of government and discipline across ministries. In this regard, the Cabinet meeting chaired by the President each May at the beginning of the annual budget process should play an important role in strengthening the commitment for fiscal consolidation.

Tax reform to enhance efficiency and to raise additional revenues

Tax reform is essential to enhance efficiency by reducing the distortions stemming from taxation and to boost revenue to meet the medium-term plan of cutting the deficit to 0.5% of GDP by 2013. With the reductions in the personal and corporate income tax rates, the main option for raising revenue is broadening the tax bases by eliminating tax expenditures. For the personal income tax, tax expenditures numbered 96 in 2006 and amounted to 22.7% of personal income tax revenue, while the 84 tax expenditures in the corporate tax system amounted to 17.2% of revenue. In addition, strengthening the local property holding tax would provide more tax revenue from a relatively non-distortionary levy while helping to limit upward pressure on housing prices. Indeed, a tax on property holding is more favourable for growth than other taxes as it has less impact on decisions to supply labour, produce, invest and innovate (Johansson *et al.*, 2008). The recommendations in the 2008 *OECD Economic Survey of Korea* for a fundamental tax reform are still relevant. Box 2.2 summarises those recommendations, as well as progress toward implementing them.

Monetary and exchange rate policy

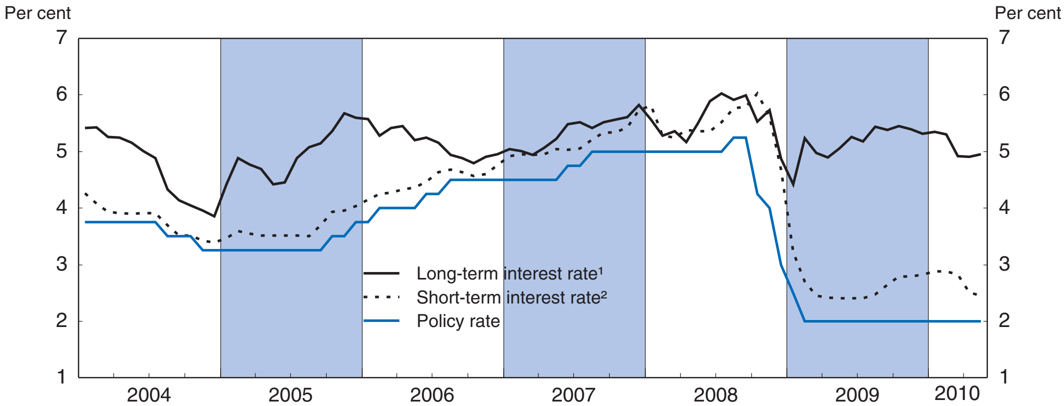
After raising the policy interest rate to 5¼ per cent in August 2008, just one month before the Lehman shock, the Bank of Korea quickly reversed course. Between October 2008 and February 2009, it cut the policy interest rate six times to a record low of 2%, where it has remained since (Figure 2.3). In addition, the Bank of Korea provided 28 trillion won (2.7% of GDP) to alleviate a credit crunch by increasing open market operations and broadening the range of assets eligible for them, raising the upper limits on its credit ceiling programme, paying interest to banks on their required reserve balances and contributing to the Bond Market Stabilisation Fund and the Bank Recapitalisation Fund (Chapter 3).

Box 2.2. **Taking stock of structural reforms: reforming the tax system**

Recommendations in the 2008 *OECD Economic Survey of Korea*	Actions taken or proposed by the authorities
Corporate income tax	
Lower the statutory rate to promote the international competitiveness of firms, thereby reducing the share of corporate taxes in direct taxation.	The standard rate was cut to 22% in 2009 and that for SMEs was cut from 11% in 2008 to 10% in 2010.
Phase out quasi-taxes.	Quasi-taxes are being streamlined by restructuring various contributions, penalties and commissions.
Broaden the tax base by reducing tax expenditures.	New tax expenditures were introduced in 2008 in response to the crisis (Table 2.2).
Avoid reliance of local governments on corporate income taxes.	No action taken.
Personal income tax	
Reduce the income tax rate to facilitate FDI, entrepreneurship and education.	The lower three income tax rates were reduced from 8-26% to 6-24% during 2009-10, while the top rate of 35% will be cut to 33% in 2012.
Reduce the tax incentives for the lump-sum retirement allowance scheme.	No action taken.
Broaden the personal income tax base.	Deductions on comprehensive income and on education expenses were increased, thus narrowing the tax base. A number of small steps to broaden the base were taken.
Further increase compliance of the self-employed by improving enforcement and hiking penalties for tax evasion.	Steps were taken to increase the transparency of self-employed income by encouraging bookkeeping by small businesses and extending the requirement to file electronic tax invoices.
Expand the Earned Income Tax Credit that was introduced in 2008.	The eligibility requirement was eased from two children to one and the maximum amount of payment was boosted from 0.8 million won to 1.2 million won.
Increase the taxation of fringe benefits.	No action taken.
Encourage the autonomy of local governments to change tax rates.	The government will change the local inhabitant tax into a local income tax, but the rate and base will remain unchanged for the next three years.
Value-added tax and other consumption taxes	
Rely on the VAT for increased revenue.	No action taken.
Use a single VAT rate.	No action taken; Korea continues to provide a VAT exemption on some products.
Maintain a broad tax base for the VAT.	Korea maintains a broad base for the VAT.
Phase out individual consumption taxes.	No action taken. However, the purpose of these taxes has been changed from offsetting the regressivity of the VAT to addressing externalities.
Phase out earmarked taxes.	No action taken.
Strengthen environment-related taxes.	No action taken.
Reduce special treatment of SMEs.	No action taken.
Avoid a local VAT as it would widen the gap between regions while failing to enhance local government autonomy.	A local VAT was introduced in 2010, with the rate aimed at reducing the fiscal gap between localities.
Property taxes	
Increase local property holding taxes.	The tax base brackets and rates were reduced in 2009 to the level of 2007.
Further reduce taxes on transactions.	No action taken.
Base the capital gains tax on the size of the gain rather than the number of houses owned.	The capital gains surtax on those owning two or more homes has been temporarily suspended.
Phase out the nation-wide Comprehensive Property Tax (CPT) over the medium term.	The government decided in principle to transform the CPT into a local tax.

Consumer price inflation fell from a peak of nearly 6% in mid-2008 to 2% in the third quarter of 2009 (Figure 2.4). In contrast to the concern about actual or potential deflation in a number of OECD countries, inflation in Korea has stayed above 2%, reflecting in part the higher starting point. Faster inflation in Korea also reflects the large depreciation of the won, which boosted import prices, in addition to promoting exports, helping to spark the strong and early recovery. The inflation rate for the first quarter of 2010 reported an increase,

Figure 2.3. **Interest rates in Korea**



1. Ten-year government bonds.
2. The 91-day CD rate.

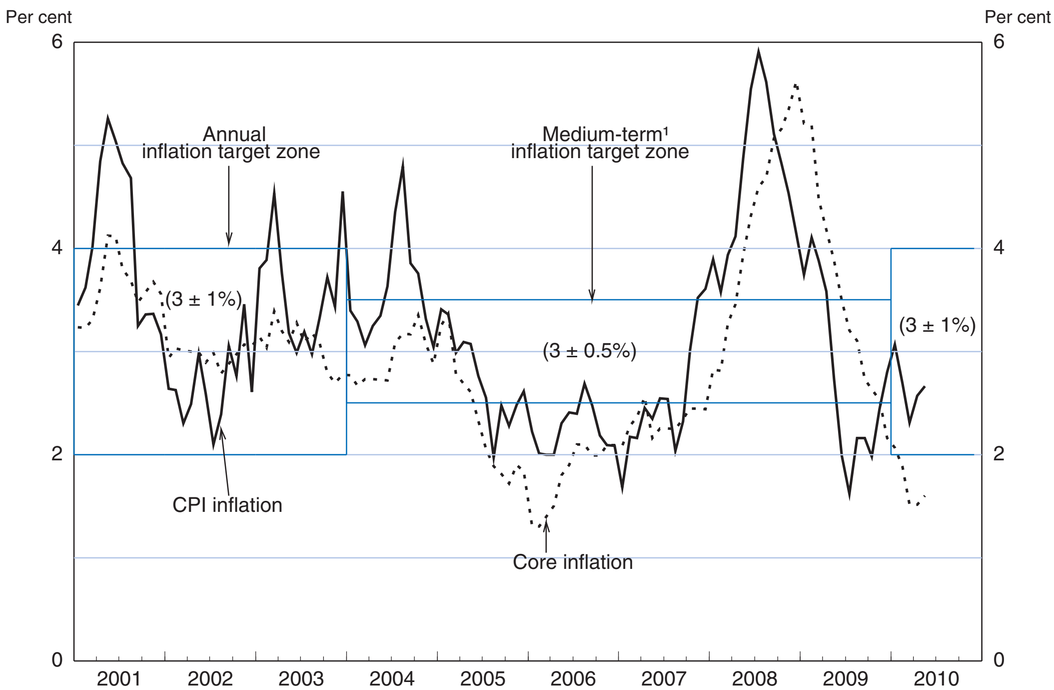
Source: Bank of Korea.

StatLink http://dx.doi.org/10.1787/888932302606

although it is still below the midpoint of the target zone, which was widened in January 2010. Consumers' inflation expectations for the coming 12 months have followed actual inflation with a lag, falling from 4.5% in mid-2008 to 3% by March 2010.

Figure 2.4. **Inflation targets and outcomes**

Year-on-year percentage change



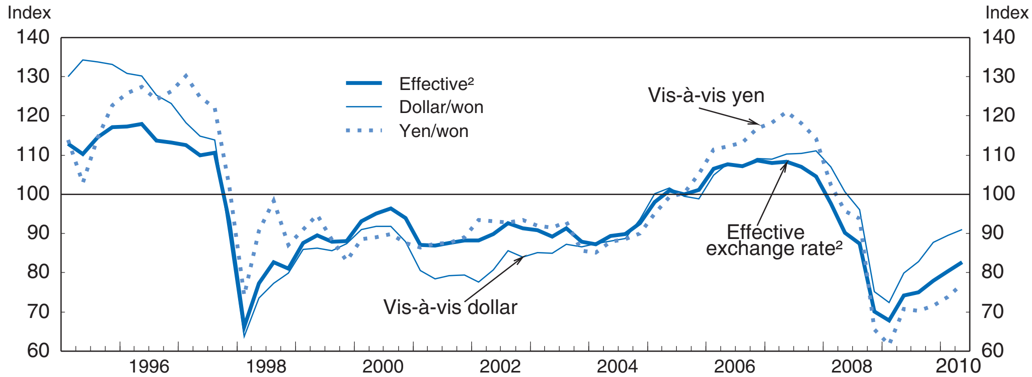
1. Since 2004, the target has been a medium-term objective and, in 2007, it was changed from core to overall CPI.

Source: Bank of Korea.

StatLink http://dx.doi.org/10.1787/888932302625

Figure 2.5. **Exchange rate trends**[1]

2005 = 100



1. A rise indicates an appreciation of the won. For the second quarter of 2010, the rate of 10 May (1 131.8 won per dollar) – on which the *OECD Economic Outlook*, No. 87 projections are based – is shown.
2. Calculated *vis-à-vis* 41 trading partners.

Source: *OECD Economic Outlook Database* and Bank of Korea.

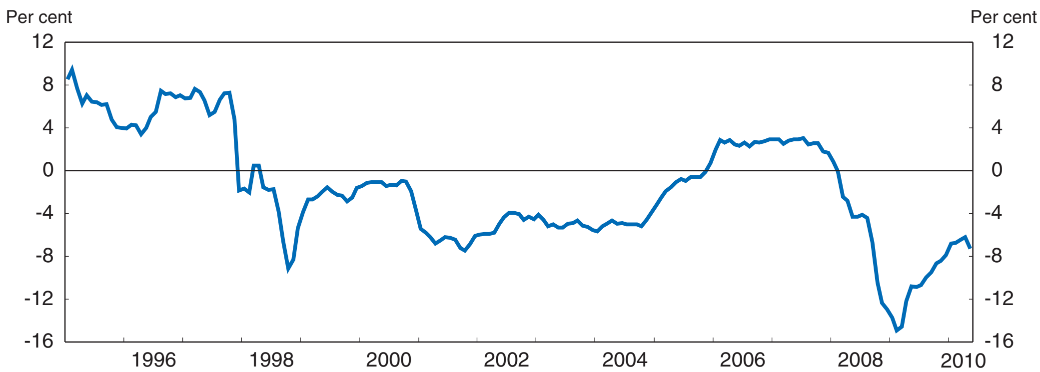
StatLink http://dx.doi.org/10.1787/888932302644

While the short-term policy rate has been steady for more than one year, monetary conditions have tightened somewhat due to the appreciation of the exchange rate (Figure 2.5). After falling 35% in effective terms between mid-2007 and February 2009, the won had rebounded almost 19% by the first quarter of 2010. The appreciation of the exchange rate has tightened monetary conditions (Figure 2.6). Nevertheless, conditions remained exceptionally relaxed, roughly comparable to the situation in 1998 in the wake of the Asian financial crisis, given the low interest rate and the weaker won, which remains about 25% below its 2007 peak in effective terms.

The relaxed monetary conditions after five quarters of positive economic growth (including strong growth in the first quarter of 2010) raises questions about the appropriate timing for normalising the policy interest rate. While the government has moved promptly to remove fiscal stimulus, it has stressed that conditions for raising the policy interest rate

Figure 2.6. **Monetary conditions in Korea**

Percentage difference with respect to the average since 1995[1]



1. An increase indicates a tightening of monetary conditions. The OECD calculates the index using a weight of 1 on the real short-term interest rate (91-day CD rate), deflated by core inflation, and a weight of 0.3 on the real effective exchange rate.

Source: *OECD Economic Outlook Database* and Bank of Korea.

StatLink http://dx.doi.org/10.1787/888932302663 were not yet met, arguing that the private sector has not achieved a full-scale recovery, the labour market remains weak and the level of household debt is worrisome. In the April meeting of the Monetary Policy Committee (MPC), the policy rate was left unchanged for the 14th straight month. In its statement, the MPC stated that "domestic economic activity has sustained a trend of recovery", which "is expected to be maintained". However, it cited overseas risk factors as creating uncertainty about growth going forward. At the same time, the Bank raised its growth projection for 2010 from 4.6% to 5.2% in April.

The real policy interest rate is negative and monetary conditions remain exceptionally relaxed at this stage of the recovery, suggesting that it is time to begin gradually normalising interest rates. Moreover, growth of more than 5% in 2010 would quickly exhaust remaining slack, particularly given evidence that potential growth rates in the OECD area have fallen in the wake of the financial crisis. Several OECD countries, as well as some non-OECD Asian countries, have already begun to raise policy interest rates. As Korea is a frontrunner in the world recovery, there is a clear case for it to follow suit. This is also important, alongside central bank independence, to uphold the credibility of monetary policy and anchor inflation expectations, which are both essential to the effectiveness of monetary policy (Minegishi and Cournède, 2010).

Korea's exchange rate flexibility has served it well, particularly during the 2008 crisis. Given the global forces putting downward pressure on the won, intervention would have been costly and ineffective. Korea thus avoided the 1997 mistake of using up foreign exchange reserves in the midst of a liquidity crisis (Cho, 2009). The crisis also demonstrated that foreign exchange reserves, which were the sixth largest in the world at nearly USD 260 billion (31% of GDP) in mid-2008, were adequate to overcome a severe crisis, including by facilitating the establishment of swaps arrangements with other countries. Although reserves did fall to USD 200 billion in late 2008, they have since rebounded to USD 268 billion, suggesting it is unnecessary to increase them further, against the backdrop of multilateral efforts to strengthen international financial safety nets (Chapter 3).

Conclusion

The priority for macroeconomic policy is to continue to support a sustainable and durable recovery from the global economic crisis. Given the pace of the upturn, the planned withdrawal of fiscal stimulus in 2010 appears appropriate and needs to be followed by more spending restraint compared to the past. Additional revenue could be obtained by broadening tax bases without worsening distortions. The withdrawal of monetary policy stimulus has been on hold, given concerns about the strength of the domestic and world economy. While there is uncertainty, it is important not to let inflationary expectations and pressures build for too long, making it important to begin normalising interest rates. Specific recommendations are summarised in Box 2.3.

Box 2.3. **Summary of recommendations for macroeconomic policy**

- Make the spending targets in the medium-term fiscal plan more binding in order to slow the pace of government spending and achieve the target of reducing the deficit in the consolidated central government budget (excluding the social security surplus) to 0.5% of GDP by 2013.
- Keep the growth in the debt of public corporations in check.
- Move ahead with the privatisation of the remaining 18 public institutions as scheduled in the 2008 plan.
- Reduce tax expenditures, particularly in the personal and corporate income tax, to limit revenue losses.
- Strengthen the local property holding tax, in part to limit upward pressure on housing prices.
- Start normalising interest rates to keep consumer and asset price inflation in check.
- Maintain the flexible exchange rate policy, which proved effective in overcoming the 2008 crisis.

Notes

1. The government's preferred fiscal measure excludes the social security surplus as this is intended to cover the future liability of public pensions, as well as the cost of financial-sector restructuring between 2002 and 2006. Korea uses the GFS measure of the government budget. General government data on a SNA93 basis are available through 2008, when it reported a surplus of 3.0% of GDP, compared to deficit of 1.7% for the consolidated central government budget, including the social security surplus (Table 2.3). The difference reflects the fact that the GFS measure does not include local government, but does include net lending items, some of which are financial in nature.
2. However, the 2010 budget is 6.6% more than the 2009 initial budget that was planned before the intensification of the global economic crisis.
3. On a general government basis, gross government debt increased from 32% in 2008 to 35% in 2009.
4. Three were listed on the stock exchange (Grand Korea Leisure Company, Korea Power Engineering Company and Korea District Heating Corporation) and three were sold outright (Farmland Improvement Company, Ansan City Development Company and Korea Asset Trust Company).
5. Most importantly, the Korea Land Corporation and Korea National Housing Corporation were merged in October 2009.
6. The National Fiscal Management Plan (NFMP) was a big improvement over the Medium-Term Fiscal Plan (MTFP) that was in effect from 1998-2003: *i)* the NFMP covers the consolidated budget, including public funds, while the MTFP focused on the general account; *ii)* the NFMP presents quantitative goals, while the MTFP only set broad directions; *iii)* the NFMP is used in budget formulation by ministries and announced publicly, while the MTFP was primarily a reference for the Ministry of Planning and Budget; and *iv)* the NFMP is revised annually while the MTFP was revised only periodically.
7. Since 2007, the medium-term fiscal plan has been more stable, as its budget targets for a given year show less variation in successive plans.
8. The medium-term plan is based on government gross lending and thus differs from Table 2.3, which is based on government net lending. The difference between these two measures is explained in the footnotes to Table 2.7.

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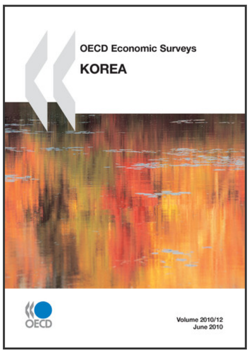

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