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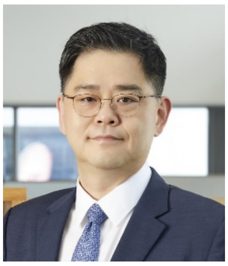
Back to Basics: Fiscal Space in a Low-growth Era



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Concerns have been raised about an even lower growth of the Korean economy after the coronavirus pandemic. Previous crises of different origins and characteristics, for example, the 1997 Asian financial crisis and the 2007-2008 global financial crisis, were followed by structural transitions to lower growth states. While the ten-year compound annual growth rate for the period ending in 2002 was 6.7 percent, the next ten years saw an annual growth of 4 percent. Growth then slowed further to 2.7 percent for the period of 2013-2022. The latest growth forecasts for the Korean economy by the Korea Development Institute are1.5 percent for 2023 and 2.3 for 2024. It is still too early to say that the impact from the recent crisis has dissipated. The ongoing Russia-Ukraine war has added to the supply-side pressures that resulted from the disruption of the global supply chain during the pandemic. But, one big question remains. Will there be another slowdown in growth?

As the Korean economy heavily depends on global demand for its products, the external sector will be the main source of possible structural change. The massive development of the global value chain led the growth of the Korean economy in the 21st century, but it is now stagnating and even declining under the prolonged strategic tensions between the United States and China.

To make matters worse, the Chinese economy, Korea's largest trading partner, is experiencing a growth slowdown, often referred to as facing the middle-income trap. According to IMF's April 2023 forecast, the annual growth rate of the Chinese economy for the next five years is 3.9 percent, down from 6.7 percent annual growth in the five years before the pandemic. The two economies share common problems such as aging population, heightened external uncertainty, and property market risk. An additional dimension that the Korean economy suffers from is the loss of relative competitiveness, as China's manufacturing productivity is rapidly catching up with the Korea's. This is evident in recent trade statistics. Korea's bilateral trade surplus with China reached as high as $62.8 billion in 2013, and decreased to $1.2 billion in 2022. By August 2023, the bilateral trade deficit will accumulate to 15.6 billion dollars. Even after addressing the memory semiconductor industry is going through the worst market in years, where China and Hong Kong together take more than 50 percent share of Korea's semiconductor exports, it is obvious that the structural change in industry and trade relations between two economies has taken place. For this reason, Korean companies in China were considering relocation or reshoring even before the U.S.-China tension worsened.

In this transition to a low-growth era, the role of the government is extremely important. Productivity improvement could be achieved through fierce competition in the private sector under fair rules, which in turn requires appropriate deregulation. Also, the industrial policy, which coordinates economy-wide investment for the future should be prepared carefully but implemented both preemptively and decisively. It is a difficult task when a slower growth is expected, as fiscal space may be limited, especially right after the crisis measures were poured during the pandemic.

Recently, the Korean government has been making efforts to improve the fiscal soundness. On the first day of September 2023, the Ministry of Economy and Finance has submitted both the budget plan for 2024 and the mid-term fiscal management plan for 2023-2027 to the National Assembly. This five-year plan shows the fiscal consolidation effort that could secure the fiscal space in the longer term. The projected public debt ratio is a serious concern. In the five-year plan for 2021-2025 that was published in September 2021, this ratio was forecast to rise from 47.3 percent in 2021 to 58.8 percent in 2025. The rapidly rising trend was first introduced in the plan for 2019-2023 and the projected level has further revised upward during the pandemic. Surprisingly, the ministry presented a rather flat schedule of 49.7-52.2 percent in the 2022-2026 plan, which required fiscal tightening under increasing external uncertainty. Doubts about the feasibility of the plan were raised and then comes another surprise in the plan for 2023-2027. The ratio is still on an upward trend, but flat. The forecasts for 2025 and 2026 are 51.9 and 52.5 percent, which are 6.9 percent point lower than that presented in 2021 and only 0.3 percent point higher than that in 2022, respectively. These efforts will restore the credibility of the fiscal soundness. In a recent IMF Article IV Mission to Korea, which concluded on September 6, 2023, the mission chief also pointed out that “with significant fiscal expansion during the pandemic and the debt-to-GDP ratio still on an upward trajectory, fiscal policy should continue to normalize, [...].” Further adjustment of budget allocation in the face of limited fiscal space could enhance the effectiveness of the government spending. Good ideas are urgently needed on how to strike a balance between securing fiscal space in the longer term and promoting productivity enhancing investment. KIEP