


Economic Policy Uncertainty and Its Implications on Economic Recovery: A Case Study of Korea



KIM Wongi

Ph.D., Research Fellow, Americas Team
Korea Institute for International Economic Policy 

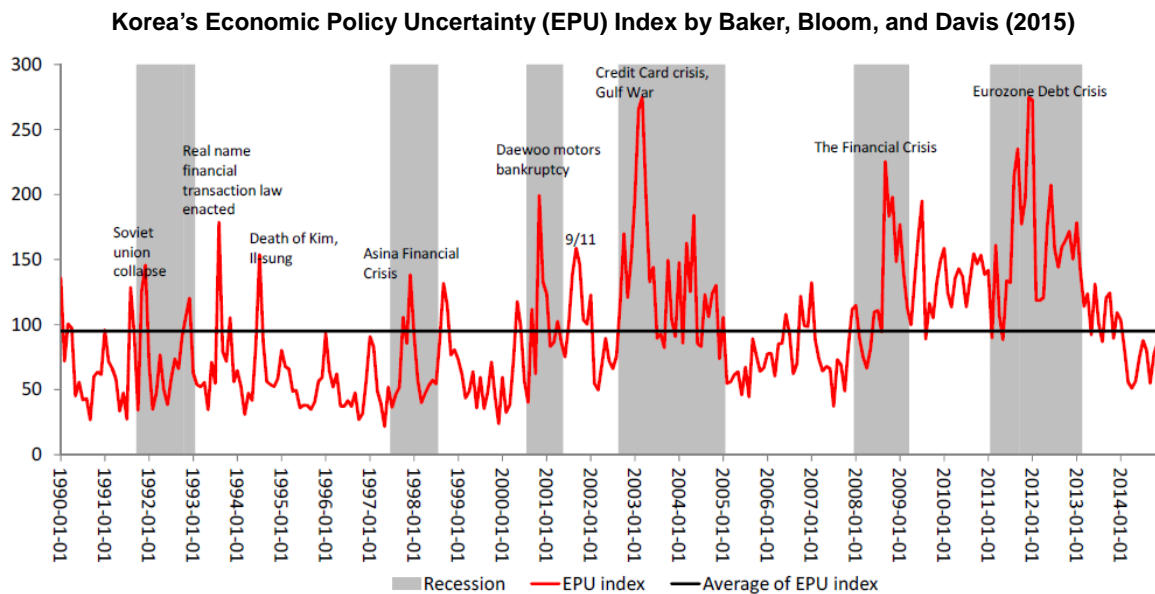
Why does economic growth remain so sluggish across so many countries after the onset of the financial crisis? What causes economic recovery to lag behind in countries including Korea? There could be many factors such as debt overhang and slow growth of total factor productivity that serve as an explanation, but several economists focus on the role of 'economic policy uncertainty'.

Economic policy uncertainty is a concept of economic risks where the 'future path' of government policy such as fiscal, regulatory, and monetary policy is uncertain. For example, if next year's tax rate is unclear - which means it can move in either direction - the ensuing conflict between economic growth and fisc-

al sustainability heightens economic policy uncertainty. Why is economic policy uncertainty so important? The future path of government policy is an important factor for privates to determine how much they consume, save, and invest today. People tend to postpone their decisions to until after policy uncertainty is resolved. For example, potential entrant firms try to delay their entrant decisions until uncertainty on tax policy is settled, because they care about after-tax profits. This could reduce overall private investment and hamper economic recovery.

Then how strongly do these negative effects of economic policy uncertainty impact economic recovery? To answer this question, we first need to discuss how to measure the 'level' of economic policy uncertainty. This is not an easy task, since the 'future path' of government policy is not directly observable. Fortunately, Baker, Bloom, and Davis (2015) (henceforth BBD) have developed the economic policy uncertainty index (henceforth EPU index) which potentially captures the 'level' of uncertainty about the future path of government policy. Basically, they count the frequency of terms related to policy uncertainty - such as 'monetary policy uncertainty' - in newspapers. The more frequently such terms appear in newspapers, the higher policy uncertainty we can consider to prevail in the economy. According to statistical investigation results using the EPU index in BBD, an increase in the EPU index from the pre-financial crisis level to the onset of the financial crisis level could reduce industrial production by 1.1 percent maximum in the U.S. This means that U.S. industrial production could be higher during the financial crisis if the U.S. government had maintained the pre-crisis level of the economic policy uncertainty.

What about Korea? How strongly do the negative effects of economic policy uncertainty impact economic recovery? To figure out an answer, we first need to look at how economic policy uncertainty fluctuates in Korea. The figure below shows that Korea's EPU index from 1990 to 2014 surges several times near major economic crises and war events. For example, the index jumps around the Asian financial crisis in 1998, the credit card crisis in 2003, the financial crisis in 2008, the 2012 Euro debt crisis, the death of Kim, Il-sung, the 9/11 terror attacks, and the Gulf War. Based on the evidence that policy uncertainty becomes higher around major crises and war events, the index seems to well capture levels of economic policy uncertainty in Korea. Also, we can observe that the EPU index in Korea tends to rise in recessions. This suggests that heightened policy uncertainty makes economic conditions worse.



Source: Bloom, Baker, and Davis (2015) and Author's calculation.

(Recession date by OECD: <https://research.stlouisfed.org/fred2/series/KORRECD>,

EPU index: http://www.policyuncertainty.com/korea_monthly.html, search date: 2015-12-27.)

Can we conclude that elevated policy uncertainty worsens economic conditions in Korea based on this eyeball test? Unfortunately, we cannot. It is obvious that high policy uncertainty in Korea could deter economic recovery, similar to the case of the U.S. At the same time, however, deep economic recession could raise economic policy uncertainty because the government usually uses several policy instruments to mitigate the effects of recession. To identify the causal effects of heightened policy uncertainty on economic conditions, I conducted a statistical analysis in line with BBD. The results show that an increase in the EPU index from the pre-crisis level to the onset of the financial crisis level could reduce industrial production by 1.2 percent at maximum. This result, which is similar to the U.S. example in BBD, implies that an increase in economic policy uncertainty is a potential cause of slow economic recovery in Korea in the aftermath of the financial crisis.

What are the policy implications of this outcome? One is that clear communication between privates and the government is necessary to improve the performance of economic policy. For example, the government of Korea has recently expanded government spending to boost economic activity. On the one hand, an increase in government spending could stimulate private activities through several channels. On the other hand, an increase in government spending could heighten economic policy uncertainty because of potential fiscal sustainability problems in the event that 'further guidance' from the government is not provided. This uncertainty could offset the stimulus effects of increased government spending. In fact, the optimal

level of government debt and taxes has been an active discussion in Korea, and this in itself raises uncertainty.

Oliver Blanchard, the former chief economist at the International Monetary Fund, said "Uncertainty is largely behind the dramatic collapse in demand. Given the uncertainty, why build a new plant, or introduce a new product? Better to pause until the smoke clears." Economic policy uncertainty is one of the key factors that determine private agents' behavior. Korea has recently suffered from slow economic recovery, and one of the reasons behind this is assumed to be unclear economic policy. It is time for more clear and transparent communication between the government and privates. [KIEP](#)

References

1. Baker, Scott R., Nicolas Bloom and Steven J. Davis. 2015. "Measuring Economic Policy Uncertainty." NBER Working paper, No. 21633, October.
2. Lo, Stephanie and Kenneth Rogoff. 2015. "Secular Stagnation, Debt Overhang and Other Rationales for Sluggish Growth, Six Years On." BIS Working paper, No. 482, July.