

Consequences of Korea ' s Economic Crisis

By *Kyung-Hwan Kim*

The currency crisis and the subsequent bailout by the International Monetary Fund (IMF) in December 1997 came as a shock to most Koreans who had taken rapid economic growth for granted for more than three decades. It was even more devastating since the crisis came shortly after the country had joined the Organization for Economic Cooperation and Development (OECD) and its per capita income reached the \$10,000 mark.

Negative growth and massive unemployment have become a reality in a country in which the economy grew at an annual rate of 8 per cent and the official rate of unemployment stood below 3 per cent. For the first time since 1980, Gross National Product (GDP) dropped 3.8 per cent during the first quarter of 1998 and is believed to have dropped 4 per cent during the second quarter. The annual economic growth rate is predicted to be between 3 and 5 per cent. Unemployment rate reached 6.9 per cent in May 1998 and is expected to rise further as restructuring proceeds. And wages are being cut for most workers. Consequently, the average income of urban wage-earner households fell 2.2 per cent in nominal terms and 10.8 per cent in real terms during the first quarter of 1998.



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Falling Local Government Revenue

The economic crisis has had a serious impact on local government finance and urban services. Korean local governments provide a wide array of services and mobilize the required resources from local taxes, user charges and fees, general-purpose grants and project-tied subsidies from the national government. Independent local education

administrations are responsible for primary and secondary education and they rely heavily on transfers from the national government for funding.

Local government revenue from all possible sources is decreasing substantially due to the economic crisis. Local tax revenue suffers from the erosion of tax base and the taxpayers' inability to pay. The largest contributions to local tax revenue come from taxes on transactions and holding of real estate and automobiles. As the real estate market becomes sluggish and the automobile sales decline sharply, the tax revenue from these sources is falling rapidly. Tax collection efforts are also frustrating because of the taxpayers' loss of income. Raising water tariffs and other charges is made difficult for similar reasons. And the decrease of national tax revenue is translated into reduced allocations of general-purpose grants to local governments and local education administrations because the allocations are determined as a fixed percentage of national tax revenue. Tight national budgets also lead to a decrease in project-tided subsidies to local governments.

Faced with the revenue shortfall, local governments are trying to cut costs by reducing staff and other recurrent expenses. But they are also forced to postpone and even cancel some infrastructure projects such as construction of subways and light-rail, roads and wastewater treatment facilities. Local governments with inadequate revenue bases are in danger of collapsing as many cannot afford to pay salaries to their staff.

Attempts to solicit private sector participation in urban infrastructure finance has proved difficult due to high interest rates and the financial crunch facing the private sector. Moreover, local authorities need to allocate some resources in order to provide a social safety net to the unemployed and the growing low-income population. In summary, local governments' ability to provide urban services is being undermined by the current economic crisis.

Shrinking Housing Market

The housing sector has been most severely hit by the economic crisis. Demand for housing is shrinking due to reduced incomes and increasing unemployment. High interest rates and the decrease in the supply of mortgages, as well as the pessimistic expectations about housing prices in the near future suppress the demand for owner-occupied housing even further. The market for owner-occupied housing in Korea was driven by the expected capital gains, but the fall in housing prices since the economic

crisis began has changed the perception of many home-buyers. In addition, financial products guaranteeing high returns diminished the attractiveness of housing as an investment. As a result of the sluggish demand, the number of unsold new apartments is rising to a level that is equivalent to almost 30 per cent of the annual production.

The housing industry is suffering badly from high interest rates and the credit crunch. Many homebuilders went bankrupt this year and many more are on the verge of bankruptcy. The reduction in demand and the financial trouble faced by the housing industry have led to a sharp decline in the supply of new housing. The annual production of housing had averaged 600,000 units in the 1990s. But housing supply during the first four months of 1998 was 30 per cent less than that of the same period in 1997. And housing production is projected to drop by an estimated 300,000 units in 1998. Since it takes 2 to 3 years to construct high-rise apartments and since there is still a shortage of housing in the Seoul metropolitan area, the decrease in new housing supply now might result in a price increase if and when the economy recovers.

The Government has introduced various measures to boost the housing sector. It recognizes that this sector is labor-intensive and hence capable of absorbing many of the unskilled workers who are jobless. The Government is also worried about the possibility of a vicious cycle of an abrupt drop in housing prices leading to the reduction of household consumption and the increase in non-performing assets of financial institutions. Recently announced policy measures to address this problem are quite comprehensive. They include tax breaks to facilitate transactions, the lifting of various regulations to make housing less costly to supply, and the provision of additional funds for housing finance to help those who have difficulty making installment payments for home purchases. However, the response of the market so far has not been very impressive.

Increased Homelessness

The problem of homelessness has also emerged as a housing and social policy issue for the first time. The number of homeless had been negligible and homelessness was seldom considered as posing a serious problem until the on-going economic crisis started generating massive unemployment. Currently, the homeless population is estimated to be about 3,000 nationwide; 70 to 80 per cent of them located in Seoul, the capital city. About 85 per cent of the homeless are jobless, partly as a result of the economic crisis. The number of homeless is expected to rise to 6,000 by the end of

1998. The Government and local authorities are responding to the problem by supporting the initiatives of selected religious institutions and social activist groups that provide shelter and food to homeless people as well as directing the homeless into vocational training programmes. But the fundamental problem of homelessness results from the lack of an adequate social safety net. And it has serious ramifications in terms of destabilizing family structures on an unprecedented scale.

Silver Lining

Although the current economic crisis in Korea has deeply affected various sectors of the economy, including local government and housing, it provides an impetus for structural reform. Local government reform is being pursued as an integral part of public sector reform aimed at streamlining its organization and enhancing its productivity in service delivery. The role of Government in the housing sector has also transformed to that of a facilitator and a provider of a social safety net to those who cannot afford market solutions. These are certainly positive developments.

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