

Economic Survey of Korea, 2003

Summary

Korea's economic recovery in 2002 in the face of a sluggish world economy was based on progress in implementing a broad restructuring programme, accompanied by appropriate macroeconomic policies. However, this should not lead to complacency about resolving remaining structural weaknesses and addressing emerging imbalances. In particular, the acceleration in wages and the sharp increase in real estate prices risk boosting inflationary pressure, suggesting that a gradual reversal of monetary easing would seem to be needed so as to keep inflation in its medium-term target range during the expansion projected over the next two years. Moreover, shifting the policy focus to the medium term and ensuring central bank independence and accountability in setting monetary policy would enhance the chances for a successful inflation-targeting policy. Meanwhile, fiscal consolidation is necessary given the significant cost of financial-sector restructuring, as well as longer-term spending pressures, in part, related to ageing. Achieving a structural fiscal balance by 2007, excluding the social security surplus, would be an appropriate objective in this respect. Meeting this goal will require both tax-base broadening and more efficient public expenditure. The public expenditure system should be reformed to enhance efficiency and transparency. Consolidation of the highly compartmentalised budget structure should be a priority, while aggregate spending control should be ensured by anchoring expenditures in a medium-term framework. Reform of the pension system is essential to contain the fiscal impact of ageing. Although

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For further information

This Policy Brief presents the assessment and recommendations of the 2003 OECD Economic Survey of Korea. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

this is a long-term issue, it should be near the top of the policy agenda given the difficulty of implementing fundamental changes once the current scheme begins paying regular pensions in 2008. Policies that maintain a low level of structural unemployment and encourage the upward trend in the labour force participation rate will also help cope with the fiscal effects of ageing. More generally, the welfare of all Koreans will be enhanced by policies to maintain Korea's high growth potential. This requires improvements in the education and R&D systems and enhancing competition by pursuing the on-going initiatives to remove impediments to direct investment, lower trade barriers, reform regulations and strengthen competition policy. Corporate and financial sector restructuring efforts need to continue. One priority should be the privatisation of the banks that received public money following the crisis, which is essential to accelerate corporate restructuring. Corporate restructuring will also be aided by the new corporate governance framework and improved bankruptcy procedures. At the same time, sustaining high growth will require greater focus on environmental issues, notably the need to reduce air pollution and improve waste management. Moving ahead with the structural reform programme, while implementing policies to ensure macroeconomic stability, will help Korea to maintain high growth rates and continue its convergence to the income levels in the most advanced countries. ■

How has Korea been able to achieve an economic recovery despite a weak global economy?

Korea's recovery in 2002, which boosted output growth to 6 per cent despite a sluggish world economy, reflects both the success of the economic restructuring programme initiated in the wake of the 1997 crisis and the underlying dynamism of the economy. Reform efforts have strengthened the mechanisms for resource allocation through market forces and significantly altered the legal and institutional settings to improve governance. They have also created positive synergies with macroeconomic policies. In particular, the restoration of healthy bank balance sheets has strengthened the transmission of monetary easing to the economy, as slowing credit growth to the enterprises in the wake of corporate restructuring has been more than offset by buoyant lending to households, in part through credit cards.

At the same time, tax reform measures to encourage credit-card use and thereby increase tax compliance have broadened the tax base and helped to keep the government budget in surplus. These developments laid the foundation for a rebound from the 2001 downturn led by private consumption and housing investment. However, the recovery has been accompanied by a sharp increase in household debt, rising inflationary pressures and a steep rise in real estate prices, prompting the government to take numerous measures to stabilise the housing market. Even though private consumption and housing investment are likely to moderate, output growth in the 5½ to 6 per cent range is projected for 2003 and 2004, assuming that there is a pick up in the world economy that results in a recovery in external demand. The challenge for Korea is to maintain its high growth potential by overcoming remaining structural weaknesses through further reforms, while keeping inflationary pressures under control and containing potential financial imbalances through appropriate macroeconomic policies.

Korea is well placed to meet that challenge. The priorities for reform are likely to create additional positive synergies with macroeconomic policies. This is particularly the case with respect to privatising the banks that were re-capitalised with public money. Such privatisation would not only promote further corporate restructuring but also generate revenues to alleviate somewhat the fiscal burden of the financial-sector restructuring programme. Even so, given the large size of these costs and long-term spending pressures, the scope for discretionary fiscal policy actions will remain limited, leaving the task of aggregate demand management largely with the central bank. ■

What should be the role of monetary policy?

While inflation is currently within the central bank's recently revised medium-term target of 2.5 to 3.5 per cent, inflationary pressures may be building up, necessitating a policy response by the Bank of Korea. Following a series of cuts, the policy interest rate had remained at a record low of 4 per cent from September 2001 until it was raised by 25 basis points in May 2002. In the meantime, wage growth accelerated to 10 per cent in the first half of 2002, in the context of an unemployment rate below 3 per cent, pushing up unit labour costs by an estimated 7 per cent. In addition, the sharp rise in real estate prices

may boost inflation through their influences on housing costs, inflationary expectations, wealth effects and higher production costs. While the absence of further central bank action since last May is understandable given the considerable uncertainty about the world economic outlook, a gradual reversal of the monetary easing would seem to be needed to contain inflationary pressures during the expansion projected over the next two years.

Locking in the benefits of the moderate inflation rate that has been maintained since the crisis would be facilitated by measures to improve the inflation-targeting framework that was established in 1998. One weakness in the current framework is the focus on annual targets that are set in consultation with the government as mandated by law. Given the long time lags in the impact of monetary policy, the emphasis on the annual target is inappropriate. Furthermore, experience in other OECD countries demonstrates that the chance of success of inflation targeting is increased by the independence of the central bank, which has been enhanced in Korea since 1998. However, some aspects of the legal framework, including those covering the composition of the Monetary Policy Committee, need to be improved so as to ensure the neutrality of Committee members. Moreover, if the government's authority to overturn the Committee's decisions is ever to be used, it should be accompanied by full transparency. Measures to ensure the instrument independence and accountability of the Bank of Korea in taking monetary policy decisions would promote the success of the inflation-targeting framework. ■

Should fiscal policy give priority to balancing the government budget?

While monetary policy is focused on the inflation objective, fiscal policy aims at a balanced budget, excluding the surplus in the social security funds. By this measure, the budget recorded a surplus estimated at 0.2 per cent of GDP in 2002. The emphasis on consolidation is appropriate, given the costs incurred for financial-sector restructuring. Government-guaranteed bonds amounting to nearly 18 per cent of GDP were issued to finance this programme. About half of these bonds, most of which reach maturity between 2003 and 2006, will be re-financed by public bonds. In 2003, such borrowing is expected to amount to 2¼ per cent of GDP.

A slight fiscal tightening is planned for 2003. Although the budget (excluding social security) is expected to record a deficit of around 2 per cent of GDP, this is due to the financial-sector restructuring programme noted above. Excluding this borrowing, the authorities would achieve their balanced-budget target in 2003. The planned fiscal stance appears appropriate in the context of a continued expansion. However, the automatic fiscal stabilisers, though small, should be allowed to operate, and there is scope for limited discretionary fiscal measures if the economic expansion were to stall.

With the costs of financial-sector restructuring remaining large during the period 2004 to 2006, the budget (excluding social security) is likely to remain in deficit. Korea should aim at balancing the budget over the cycle in the period 2007 and beyond. Maintaining sound public finances is essential to cope with longer-term spending pressures, including the costs of economic co-operation with North Korea and the fiscal impact of population ageing. Excluding the social security funds from the fiscal target is justified by the need to ensure that the pension fund surplus provides resources to meet the future consumption needs of the elderly, which will increase sharply. Indeed, the proportion of the population over the age of 65 is projected to double from 7 per cent at present to 14 per cent by 2020. ■

What policies are needed to cope with the rapid ageing of Korea's population?

Weaknesses in the pension system make it essential to enact fundamental reforms, particularly given the rapid pace of population ageing compared with other OECD countries. The government should not wait to address the deficiencies in the current system. Instead, it is crucial to address a number of problems before the National Pension Scheme begins paying regular benefits in 2008. *First*, to provide the 60 per cent replacement rate targeted under the current system, the contribution rate would have to double to nearly 20 per cent, implying adverse consequences for the labour market. Lowering the replacement rate would limit the necessary rise in the contribution rate. *Second*, around a quarter of those eligible for the public pension scheme do not contribute, while many, notably the self-employed, pay too little because they significantly under-report their income. *Third*, a better private-sector system for retirement saving should be

introduced. This could be accomplished by reforming the existing separation allowance into a corporate pension system. Together with voluntary arrangements for long-term saving, these reforms would help achieve sustainable retirement incomes based on a three-tier system, as advocated in the 2001 *OECD Economic Survey of Korea*. Given the gaps in coverage and the relatively recent introduction of the system, it is important to strengthen public assistance for the elderly to alleviate poverty. ■

What should be done to improve the tax system?

Even with the implementation of reforms, outlays on public pensions and healthcare are likely to rise with an ageing population and the development of a social safety net, thus necessitating increased revenues for the public sector. Boosting revenues under the current tax system would magnify the impact of the distortions embedded in the system, which at present are mitigated by the low level of taxes. To minimise such negative effects, it is important to reform the tax system, in particular by reducing the generous allowances and tax credits, which mean that half of all individual income earners do not pay income tax. The tax bases of the corporate and value-added taxes should also be broadened by reducing preferences and exemptions. Finally, capital income should be taxed more evenly across sources to enhance equity. ■

How can the public expenditure management system be made more effective?

Improvements in the tax system should be accompanied by reforms to make the public expenditure system more efficient and effective. At 22½ per cent of GDP, Korea has the second-lowest level of public spending among OECD countries. While the immaturity of the social welfare system and the low level of public services are primarily responsible, Korea's tradition of prudent fiscal management has also contributed to containing spending. Although the public expenditure system has been effective until now in maintaining aggregate fiscal discipline, it is not geared toward achieving an efficient allocation of resources and maximising value for money. Furthermore, maintaining fiscal discipline will become

increasingly difficult, given the longer-term spending pressures that will significantly boost the size and share of non-discretionary spending in the government budget. Since 1998, the authorities have introduced a range of reform measures to address these issues, resulting in significant progress. Based on this experience, the new government should launch a comprehensive reform strategy along the lines presented below to improve the effectiveness, efficiency and transparency of the public expenditure management system.

Ensuring fiscal sustainability in the face of steadily increasing spending pressures requires the government to set its budgetary priorities in a medium-term context. Annual budgets should be developed in a medium-term expenditure framework that would provide a strong budgetary anchor and discipline on policymakers, while enhancing fiscal transparency and the ability to reallocate spending towards emerging priorities. Fiscal sustainability would also be enhanced by reforms to make the budgetary system more comprehensive. The highly compartmentalised and fragmented budget structure, with its extensive reliance on earmarked revenues, hampers aggregate control and transparency, as well as the capacity to allocate resources in line with strategic priorities. Consolidating special accounts and public funds so as to reduce drastically their number and their share of expenditure is crucial. The comprehensiveness of the budget also needs to be improved by bringing extra-budgetary funds into the budget and conducting fiscal policy on the basis of general government data, which would also enhance fiscal transparency.

Providing adequate incentives and control mechanisms in central and local government administration, as well as in public-sector agencies, is necessary to increase the effectiveness of public spending. Korea can draw on OECD country experience in moving from its traditional system of input-focused budgeting and management to one centred on outcomes. The current trend towards allowing line ministries and agencies more flexibility and autonomy should also be pursued. However, the current budget classification system and the emphasis on detailed line item budgeting and control needs to be reformed so as to encourage a focus on the performance of programmes. The shift toward more flexible and results-focused budgeting and management should go hand in hand with measures to strengthen transparency and accountability for performance.

Expanding the capacity of the Board of Audit and Inspection to conduct value-for-money audits at both the central and local government level is essential in this regard. Moreover, the use of feedback from audits and evaluations should also be strengthened.

Enhancing the role of market mechanisms would also help boost the efficiency of publicly funded services. Korea has been moving in this direction through, for example, private-sector participation in public investment projects and the contracting out of non-core government functions. Policymakers should explore the wider use of market-based instruments such as internal contracts, vouchers, and user charges, while being careful not to compromise other goals, including equity objectives.

Korea also faces the important challenge of making decentralisation more effective. The devolution of power should provide more autonomy and flexibility to local governments while, at the same time, increasing accountability and strengthening incentives for efficiency in public spending. The current system of strict controls imposed by the central government on borrowing by local governments should help ensure responsibility. To make decentralisation more effective, the rules for the central government's equalisation transfers to the local level should be improved so as to make them the key instrument for ensuring horizontal equity between jurisdictions. The conditional portion of these transfers should be minimised and the allocation criteria should be made more clear and objective to enhance transparency and accountability. The central government should also follow through on its plan to integrate small, specific grants into more general, multi-purpose grants, thus increasing local autonomy. Such grants should be designed so as not to discourage local governments from addressing important local priorities. ■

What policies would promote the development of a knowledge-based economy?

Education is a case in point. Although the performance of Korean secondary students on international standardised tests is outstanding, there is widespread dissatisfaction with the public education system. Despite some improvement, the current approach discourages local governments from investing in schools, contributing to inadequate facilities and the

largest class sizes in the OECD area. While such problems can be dealt with through increased investment, more fundamental reforms are needed to improve the quality of teaching and expand the scope of choices in schools and curriculum. These weaknesses have forced families to rely on private educational institutes to supplement the education provided by the schools, putting a burden on household budgets and undermining equity objectives. Granting schools more autonomy and expanding the pilot programme that allows the creation of independent schools would foster more competition and diversity at the secondary level, while vouchers could be used to address equity concerns. The university system – the weakest area of the education system – could also be upgraded by permitting more autonomy and enhancing accountability for private institutions and increasing public expenditure, which is exceptionally low.

Despite the government's recent efforts to improve the conditions for R&D, the deficiencies at the university level, which has a third of R&D manpower, have negative implications for the development of science and technology. While Korea spends nearly 3 per cent of GDP on R&D programmes, their effectiveness is limited by a lack of interaction between the universities, government research institutes and the private sector. Achieving more mobility of researchers between sectors and strengthening international links, while exercising caution in targeting specific areas for research, would help promote the development of a knowledge-based economy. Small and medium-sized enterprises (SMEs), led by venture businesses, have been playing a leading role in this regard. To ensure the dynamism of this sector, it is important to further reduce measures protecting SMEs and to rationalise the large number of programmes providing support. The government should scale back its involvement in the venture business sector, where it supplies a significant share of the funds of venture capital firms, as well as equity guarantees. The rehabilitation of the financial sector has enhanced the availability of funding for new enterprises, thus reducing the rationale for public financing. ■

How can corporate restructuring be accelerated?

The rapid restructuring of the financial sector was achieved through outlays totaling 157 trillion won

(27 per cent of GDP), an upgrading of prudential supervision and the closure of non-viable institutions. The banking sector is again profitable and non-performing loans have fallen to a record low. It is important that the Financial Supervisory Commission require banks to maintain their healthy status in the face of future challenges, such as rising credit-card delinquency and asset price fluctuations. Following the re-capitalisation of financial institutions using public money, the government owns a substantial share of the banking sector. Despite government efforts to ensure independent and responsible management of the banks it owns, privatising them is essential to remove any doubts about government intervention in the management in the banks, which would pose more obstacles to the restructuring of the corporate sector, where there are still a large number of weak firms. More than a quarter of enterprises are failing to earn enough profit to cover the interest on their debt, creating a risk of a rise in non-performing loans. While bankruptcy procedures have been substantially improved since the crisis, further streamlining the process would help to make it a more effective tool for restructuring. It is also important that there be effective monitoring by shareholders and creditors, which would be facilitated by introducing class action suits to protect shareholders from fraudulent practices. The new corporate governance framework appears to be taking root, as the market has rewarded companies that have good practices in this area. Ensuring that corporate governance is effective in practice will help strengthen the restructuring process and enhance the prospects for growth. ■

What policies are needed to strengthen competition and ensure flexibility in factor markets?

Promoting competition is also important in helping to maintain Korea's high growth potential. One important aspect is maintaining the open environment for foreign direct investment that was established in the wake of the crisis. Such inflows have fallen from the \$15 billion level in 1999 and 2000, to \$11 billion in 2001 and \$9 billion in 2002, in the context of a sharp decline in global direct investment flows. The environment for direct investment will depend in part on the transparency of regulation, making continuing efforts of the Regulatory Reform Committee important in this regard. In addition to abolishing unnecessary

regulations, the Committee should guard against the tendency of officials to impose regulations that are not backed by legislation. Further reducing barriers to trade, particularly in the service sector, would also enhance competition and promote Korea's ambition of becoming a regional hub. The agricultural sector, which receives large-scale assistance equivalent to 5 per cent of GDP, is another priority for trade liberalisation. The shift from market price supports to direct payments, which are less distortionary, should continue. At the same time, accelerating the upward trend in the average farm size appears important to boost productivity in this sector.

The Korea Fair Trade Commission also has a key role to play in strengthening competition, in part through the "Clean Market Project", which focuses on sectors characterised by anti-competitive practices in products that are important to consumers. Furthermore, the on-going development of the corporate governance framework and the financial sector should allow an easing of chaebol-specific regulations. The government's policies to enhance competition in the electricity and telecommunication industries are particularly important. For electricity, the ten-year restructuring plan is proceeding with the privatisation of the generating companies that started in 2002, though at a slower pace than planned. Accelerating the timetable to allow households to benefit from competition earlier than at the end of the decade would be beneficial. Measures to enhance competition in the telecommunications sector include privatising Korea Telecom, unbundling the local loop and introducing a new framework for setting interconnection charges. However, it is important to ease licensing procedures for new entrants. Moreover, there is a need for independent and pro-active regulatory bodies for both telecommunications and electricity to ensure a smooth transition to competition.

Flexible factor markets are an important aspect of maintaining high growth in Korea, where structural change has been very rapid. While the labour market is characterised by significant wage flexibility, the high costs of dismissing regular workers may be contributing to a growing proportion of non-regular employees and the emergence of a dualistic labour market. This creates both efficiency and equity concerns. Extending the social safety net for non-regular workers, while enhancing employment flexibility for regular workers, may limit such problems. As for the land market, ensuring an efficient use of land is essential in Korea, given the exceptionally

high population density and the concentration of nearly half of the population in the capital region. The sharp increases recently in the housing market suggest that the effective tax rate on holding property should be gradually raised from its currently low level and reformed to make it less regressive. ■

What needs to be done to ensure that growth is environmentally sustainable?

Addressing environmental issues is essential to ensure that growth is sustainable over the long term. Although, such issues became part of the national policy agenda in the 1990s, there have been challenges in balancing the differing interests of the government at the local and national level. Despite progress made in some areas, air pollution remains a serious problem that requires further policy efforts to reduce emissions from diesel vehicles, which account for a large part of urban pollution. A three-pronged strategy is needed to reduce the tax advan-

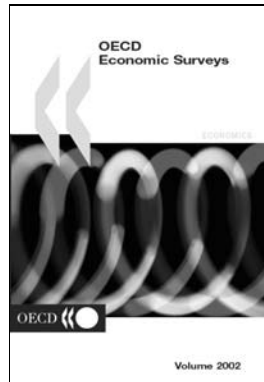
tage for diesel vehicles, to raise emission standards and fuel quality for such vehicles and finally to move toward road pricing in order to reduce congestion – itself a source of increased pollution. As for waste management, the volume-based charging system introduced in 1995 has been successful in reducing municipal waste, although the cost of garbage bags should be gradually increased. The introduction of a system of extended producer responsibility for recyclable products needs to be carefully monitored in order to ensure that recycling does not generate costs in excess of waste disposal methods such as incineration, including the environmental externalities of such disposal methods. ■

For further information

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For further reading

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- **Economic Outlook No. 72**, December 2002. More information about this publication can be found on the OECD's Web site at www.oecd.org/eco/Economic_Outlook.

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Public Affairs and Communications Directorate.
They are published under the responsibility of the Secretary-General.

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