

Economic Survey of Korea, 2001

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Summary

Korea has made impressive progress since the crisis in establishing a market-oriented framework and in achieving a strong economic recovery. However, this framework needs to be implemented effectively in order to restructure the corporate and financial sectors and ensure that the hard-won gains obtained as a result of the crisis and severe recession are not squandered. Although significant progress has been achieved, corporate restructuring should be stepped up, in part through allowing non-viable firms to exit. It is important to ensure that the exit mechanism functions properly, so as to avoid having non-viable companies continue to absorb resources at the expense of their competitors, thereby reducing potential growth. Moreover, corporate restructuring should be based on active corporate governance and transparency in accounting, disclosure and auditing procedures. The authorities should ensure that government guarantees do not distort competition or delay restructuring and should move ahead with the privatisation of banks. Progress in restructuring would not only improve the prospects for an early economic recovery, but would also reduce Korea's vulnerability to crisis and enhance the long-term growth potential. The country's growth capacity also depends on maintaining macroeconomic stability, in particular by establishing the credibility of the inflation-targeting approach. This might be better accomplished by moving away from annual inflation targets and focusing instead on the central bank's medium-term target. At the same time, it is important to

This Policy Brief presents the assessment and recommendations of the 2001 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.

develop a medium-term framework for fiscal policy, which integrates all government expenditures and is more transparent. While automatic stabilisers should be allowed to operate to help achieve an economic recovery, a sound fiscal position is essential to cope with the future costs of North-South co-operation and population ageing. Given the rapid demographic transition and the immaturity of the present pension system, establishing a system of old-age support that relies more on private-sector savings and covers a larger share of the population should be a top priority. Overall, implementing the new market-oriented framework and accelerating corporate restructuring, combined with policies to ensure macroeconomic stability in the long run, would help Korea maintain high growth rates, thus continuing its convergence to the highest income countries. ■

What caused the economic downturn at the end of 2000?

Korea achieved a strong recovery from the 1997 crisis and 1998 recession, with output increasing nearly 11 per cent in 1999 and 9 per cent in 2000. The implementation of wide-ranging reforms to create a market-based economy laid the foundation for the expansion by boosting investor confidence, encouraging large capital inflows and helping to normalise financial-market conditions. The reforms included measures to boost competition, strengthen corporate gover-

nance and resolve problems in the financial sector, in part through the use of public money to address the non-performing loan problem and to recapitalise financial institutions. With this new framework in place, the Korean economy benefited from buoyant world demand, particularly in the information and communications technology (ICT) sector, and its improved competitive position as a result of exchange-rate depreciation. Supportive macroeconomic policies also contributed to the strength of the recovery.

Korea's strong recovery came to an end in the fourth quarter of 2000 as output declined at a 1.7 per cent annual rate. The downturn was due to a mixture of negative external and domestic factors. On the external side, the

sharp rise in oil prices had a major impact on Korea, which relies on oil imports for half of its energy needs. The resulting 12 per cent decline in the terms of trade limited the growth of national income to 2.3 per cent. This was accompanied by a deceleration of world growth, which reduced demand for Korean exports, particularly in the ICT sector. Such exports, which had been growing at a 139 per cent annual rate in volume terms in the second quarter of 2000, slowed to under 40 per cent in the final quarter.

On the domestic side, there was a marked decline in confidence in both the household and business sectors during the course of 2000, despite output growth of nearly 10 per cent until the final

Macroeconomic performance at a glance

	Average 1991-97	1998	1999	2000
Year-on-year percentage changes in real terms				
Demand and output				
Private consumption	6.4	-11.7	11.0	7.1
Government consumption	3.7	-0.4	1.3	1.3
Gross fixed capital formation	5.3	-21.2	3.7	11.0
Final domestic demand	5.7	-14.0	7.6	7.7
Stockbuilding ¹	-0.1	-5.5	5.4	-0.9
Total domestic demand	5.4	-19.8	14.7	6.7
Exports	14.7	14.1	15.8	21.6
Imports	11.2	-22.1	28.8	20.0
Foreign balance ¹	0.5	12.5	-1.0	3.5
Gross domestic product	6.4	-6.7	10.9	8.8
Other indicators				
Employment growth	2.0	-5.3	1.4	3.8
Unemployment rate ²	2.3	6.8	6.3	4.1
Inflation ³	5.1	7.5	0.8	2.3
Current account				
US\$ billions	-7.8	40.4	24.5	11.0
As per cent of GDP	-1.8	12.7	6.0	2.4

1. Contribution to growth.
2. As per cent of labour force.
3. Consumer price index.

Source: OECD.

quarter of the year. While the rise in oil prices certainly played a role, the deterioration in sentiment appears to have been linked to signs that the post-crisis restructuring drive was faltering and that the problems facing the economy were larger than initially thought. This sentiment reflected a number of factors, including the following. *First*, the provision of additional public funds for financial restructuring appears to have been delayed by elections in early 2000 and political disputes later in the year. Although legislative approval for the funds was finally granted in December 2000, the delay contributed to the marked worsening in credit conditions for firms during the course of 2000. *Second*, the workout programmes for Daewoo-affiliated companies revealed considerably higher levels of debt, while negotiations to sell Daewoo Motors to a major foreign producer collapsed in September 2000. *Third*, labour unrest indicated significant opposition to restructuring. The deterioration in confidence was reflected in the fall of the Korea Stock Exchange, which declined by half during 2000, resulting in turn in a negative wealth effect.

These negative factors resulted in a deceleration of private consumption and fixed investment during the course of 2000. Unemployment, which had fallen to 3½ per cent in mid-2000, rose to above 4 per cent on a seasonally-adjusted basis in early 2001. Imports also slowed during 2000, leaving the current account in a substantial surplus of 2½ per cent of GDP. Meanwhile, the lagged impact of the increase in oil prices and public-service fees

boosted inflation from 2.3 per cent in 2000 to above 4 per cent in early 2001. ■

What are the prospects for an economic recovery?

The economy appears to have stabilised in the first quarter of 2001 as output rose by 1 per cent at an annual rate from the preceding quarter. By May, the unemployment rate had fallen to about 3½ per cent. Moreover, there was a rebound in business and household confidence, suggesting that an economic recovery could begin in the second half of the year. This outcome, though, will depend on an upturn in overseas markets, notably the United States, which accounts for nearly a quarter of Korean exports. If such an upturn does materialise, an expansion led by exports could boost economic growth to around 4 per cent in 2001 and to 5½ per cent in 2002. Growth at this rate may be sufficient to keep the unemployment rate below 4 per cent. While wage gains are likely to be moderate, further increases in employment should lead to a pick up in private consumption, in the context of rising household confidence. The recovery should also boost imports, keeping the current account surplus near its present level. Inflation is projected to moderate to about 3½ per cent in 2002 as the impact of higher oil prices and the decline in the won dissipates.

In addition to a rise in overseas demand, the prospects for an early recovery in Korea also hinge on successful restructuring of the corporate and financial sectors. Despite the progress achieved during the past few years in establishing a new legal and institutional framework, the pace of actual restructuring has been slower than might have been hoped. In part, this is due to the enormity of the problems that Korea confronted in the wake of the crisis. But slow restructuring also reflects strong opposition from labour unions and, perhaps, hopes that further government assistance would be provided, thus postponing the need for restructuring. The corporate sector, which includes a large number of financially-troubled firms, remains the major concern. Despite buoyant growth, a quarter of the companies audited externally in 1999 and 2000 did not earn enough profits to pay even the interest cost on their debt, let alone repay principal. The problems in the corporate sector, in turn, threaten the health of the financial sector. It is essential, therefore, to address the remaining concerns in the corporate sector, in part through the exit of non-viable firms. While this could have negative short-run effects, as demonstrated by the collapse of Daewoo in 1999, failing to address these issues squarely creates uncertainty that tends to undermine confidence and risks increasing the eventual cost of restructuring. Indeed, tangible progress in restructuring, particularly of the most difficult cases, could launch a virtuous circle of improved confidence, resulting in faster economic growth. ■

Performance of the corporate sector

A. Financial indicators for manufacturing firms (in per cent)

	1997	1998	1999	2000:1H	Change ¹ 1998 to 2000: 1H	2000
Financial indicators						
Debt-equity ratio	396.3	303.0	214.7	193.1	-109.9	210.6
Total borrowings-assets ratio	54.2	50.8	42.8	41.4	-9.4	41.2
Current ratio ²	91.8	89.8	92.0	95.3	3.5	83.2
Asset turnover ratio	0.92	0.82	0.78	0.88	-0.04	0.96
Profitability indicators						
Operating profit-sales ratio	8.3	6.1	6.6	8.6	2.5	7.4
Labour cost-sales ratio	11.4	9.8	9.8	9.5	-0.3	9.7
Ordinary profit-sales ratio	-0.3	-1.8	1.7	5.1	6.9	1.3
Financial expense-sales ratio	6.4	9.0	6.9	5.1	-3.9	4.7
Average interest rate	11.3	14.0	11.3	10.3	-3.7	10.5
Interest coverage ratio	0.95	0.79	1.24	1.70	0.75	1.57

B. Financial distress in the corporate sector⁴Number of firms with an interest coverage ratio³ below one in 1999

Period below one:	1999 only	1998 and 1999	1997 to 1999	1996 to 1999	Total in 1999
Total number of firms	915	565	362	170	2 012
In workout programmes	44	33	18	4	99
In court receivership	21	17	12	3	53
Normal	850	515	332	163	1 860
Total (trillion won)	112.7	37.4	26.5	9.2	185.8
(Per cent of GDP)	23.3	7.7	5.5	1.9	38.5
In workout programmes	60.6	12.3	7.5	0.7	81.1
In court receivership	2.3	2.3	2.1	0.4	7.1
Normal	49.8	22.8	16.9	8.1	97.6

1. Percentage points.

2. The ratio of liquid assets to short-term liabilities.

3. The ratio of operating profits to interest expenses.

4. Externally-audited firms, which totalled 7 805 in 1999.

Source: Bank of Korea and Wonhyuk Lim.

Is there a role for government guarantees for financially-troubled firms?

With the new market-oriented framework in place, the rationale for government intervention has been greatly weakened, even if the authorities have a continued role to play in dealing with systemic risks that arise in the course of restructuring. One concern is the maturing of 65 trillion won of corporate bonds – three-fourths of the

outstanding stock – in 2001. These include 25 trillion won below investment grade that are unlikely to be rolled over in the market. The bunching of maturities in a single year and the lack of a functioning market for low-rated debt could result in the bankruptcy of a large number of major firms over a short period, thus risking a systemic crisis in the financial market. To prevent such an outcome, the government launched “collateralised bond obligations” (CBOs) in 2000 to roll over maturing corporate bonds using partial government guarantees. This approach continues in 2001, supplemented by a bond-underwriting scheme

run by the Korea Development Bank (KDB), a public institution, for six large companies, including four Hyundai-affiliated firms.

The KDB scheme has certain safeguards aimed at preventing support for non-viable companies. In particular, the companies selected for the programme had to have their restructuring plans approved by the KDB and creditor banks. Nevertheless, the reliance on a public institution and government guarantees to roll over the bonds of weak companies risks blunting the role of market forces in corporate restructuring, creating moral hazard problems and giving the impres-

sion that some firms are still too big to fail. To limit these negative consequences, it is important that the KDB and CBO schemes be short-term in duration, be judiciously restricted to firms making serious restructuring efforts and focused on alleviating systemic risks. It is also essential to ensure transparency about the liabilities assumed and the potential cost to taxpayers. Finally, the participation of financial institutions in the schemes should be entirely voluntary.

The KDB scheme, which uses government guarantees for corporate bonds, should end in 2001, since the problem related to the bunching of maturities recedes in 2002. In addition, the CBO scheme should be phased out as financial markets stabilise. This would allow market forces to drive more fully the corporate restructuring process, including the exit of non-viable firms. Such enterprises absorb resources that could finance more productive firms, thus eroding profit margins for healthy companies and distorting competition both domestically and abroad. In October 2000, the government instructed banks to review the status of 287 weak companies, repeating the screening process undertaken in June 1998. This led to the designation of 29 companies for court receivership or liquidation. However, the number of firms screened and chosen for bankruptcy procedures is small relative to the 563 firms identified as not having earned enough profits to cover interest payments for at least three consecutive years. Moreover, the screening of firms by financial institutions should not occur at thirty-month intervals, but instead should take place on a more regular basis and

without government prompting. Legal bankruptcy procedures should be improved further, in part by the recent introduction of a “pre-packaged” bankruptcy system that limits the duration of legal procedures and gives creditors a larger role. In addition, workout programmes, which have consisted primarily of concessions on debt, should focus more on operational restructuring. Corporate restructuring vehicles, allowed since October 2000, could play a useful role in this regard. ■

Is the new corporate governance framework adequate?

While the problems of financially-troubled companies are serious, there is an impressive degree of dynamism in the business sector. New firms are created at a rate 50 per cent higher than the pre-crisis level and a growing number are classified as venture businesses. In addition, some of the surviving chaebol have begun to expand again, reversing the decline in the average number of firms in the top thirty business groups between 1997 and 2000. Given that over-expansion by the chaebol made Korea vulnerable to the crisis, it is important that such decisions are subject to oversight in the new corporate governance framework. The entrenched power of the principal owners of the chaebol as well as Korean business traditions complicate the task of activating the new governance framework. Nevertheless, there are a number of positive signs, such as the rise in shareholder activism and the introduction of outside

directors. However, there are doubts as to the independence and influence of these outside directors, most of whom are appointed by the management and principal owners of the chaebol. The use of cumulative voting, one means of allowing minority shareholders a greater voice in the selection of directors, should be encouraged by the stock exchange as a good corporate governance practice. In addition, improved corporate governance requires enhanced transparency, in part through further increasing the reliability of external audits. ■

What needs to be done to establish a more market-oriented financial system?

In short, the new market-oriented framework should be used to the full to advance restructuring in the corporate sector. This is particularly important as the problems in the corporate sector are inextricably intertwined with those in the financial sector. Indeed, it is clear that the financial system cannot be put on a sound footing as long as the degree of credit risk and instability in the corporate sector remain high. Despite the strong recovery, the banking sector as a whole recorded large losses in 1999 and 2000 due to provisioning against further increases in non-performing loans. This was partly a result, though, of the introduction of a “forward-looking” loan classification system at the end of 1999. This change seems to have encouraged banks to become more risk-conscious, caus-

ing them to reduce their exposure to large companies while increasing lending to households. At the same time, the non-bank financial sector has shrunk considerably during the past few years, reflecting the closure of many institutions. This in turn contributed to a sharp decline in the corporate bond market, where these institutions had been major players. While greater awareness of risk on the part of banks and investors is a positive development, the deterioration in credit conditions for firms was also, in part, symptomatic of continuing problems in the financial sector.

To address these weaknesses, the authorities launched in September 2000 the second-stage financial-sector restructuring plan, which includes 40 trillion won of additional public expenditure. Successfully completing this plan, so as to avoid a need for further rounds of restructuring programmes, should be a priority. Moreover, it would improve the efficacy of monetary policy (see below). The supervisory authorities should ensure that the “forward-looking” classification system is effectively implemented, which should help to expedite corporate restructuring. It is important that the financial holding company, which began operations in April 2001 with four weak banks, have managerial independence and achieve profitability in order to avoid additional injections of public funds. This is likely to require the closure of overlapping capacity. Most importantly, the privatisation of commercial banks and the development of a market-oriented financial system should be a priority. The government now owns a third of the commercial

banks, possibly posing an obstacle to bank-led restructuring of the corporate sector. Finally, it will be important to successfully conclude financial-sector restructuring given the large amount of money at stake. The second-stage programme will boost net expenditures to more than 130 trillion won, a quarter of GDP. Successful restructuring will increase the amount of these public outlays that can be recuperated. The Korea Asset Management Corporation has had impressive success in this regard in selling non-performing loans acquired from financial institutions and this should continue. ■

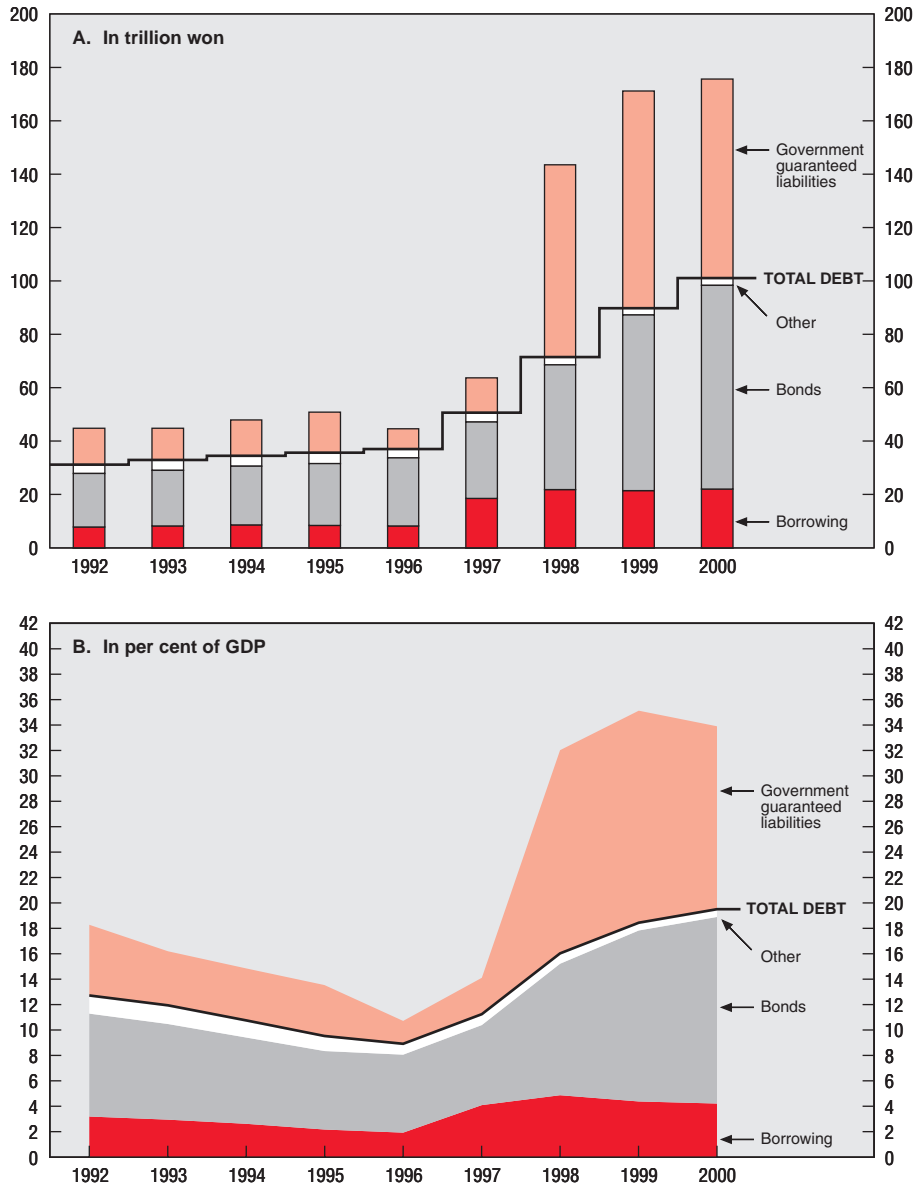
What is the appropriate stance of fiscal policy?

Given the significant rise in government debt that is likely as a result of public funding for financial restructuring, maintaining a sound fiscal policy is more important than ever. Korea achieved unexpected progress in this regard in 2000, with a record consolidated central government budget surplus, three years prior to the target under the medium-term plan to eliminate the deficit. The deficit had reached more than 4 per cent of GDP in 1998, as outlays to assist the record number of unemployed increased and tax revenues declined, before falling to below 3 per cent in 1999. In 2000, the deficit had been initially projected at 3½ per cent of GDP, but in the event, a surge in tax revenue and a shortfall in spending – 10.4 trillion won (2 per cent of GDP) – resulted in a surplus of 1.3 per cent. The increase in reve-

nue, which came in 14 per cent higher than projected (3 per cent of GDP), was mainly due to a doubling in corporate tax receipts and some reforms in the tax system. Overall, there have been some improvements in the tax system in line with the recommendations in the 2000 *Economic Survey*, such as reforming the taxation of pension income, streamlining the corporate tax and eliminating some earmarked taxes. However, further steps are needed to broaden the base of the personal income tax and the value-added tax and to improve the taxation of capital income and property.

The complicated structure of Korea's government budget, which consists of a general account and 23 special accounts that are subject to legislative approval, plus 43 public funds, which only require cabinet approval and allow the responsible ministry considerable discretion, has a number of disadvantages. *First*, it makes spending difficult to predict. Expenditures on a consolidated basis are unknown when the budget is passed, thus reducing transparency and making it difficult to monitor fiscal policy. *Second*, relying on public funds tends to blur the distinction between the public and private sectors. *Third*, the compartmentalisation of spending reduces allocative efficiency by hindering the transfer of funds to their most productive use. It is important, therefore, that the government fulfill its plan to integrate all public funds – as well as extra-budgetary funds that are not even included in the consolidated budget – into the budget submitted to the National Assembly for approval. In addition, the “Fiscal Responsibility Law” currently

Central government gross debt and guaranteed liabilities have risen since the crisis



Source: Ministry of Finance and Economy.

under discussion should be approved. This law would require the government to provide a three-year fiscal plan on an annual basis and prohibit the use of supplementary budgets except in case of a crisis. Moreover, any proposals to boost spending or cut revenues would have to provide a plan to offset the impact on the budget. The proposed law also requires the budget to provide information on contingent liabilities and quasi-fiscal activities, such as government guarantees on private-sector loans and bonds. In addition to the transparency and efficiency-related concerns noted above, a missing element in the fiscal framework is a measure of the general government balance, which should be the focus of the medium-term fiscal plan.

The emergence of a budget surplus in 2000 provides some scope for allowing the automatic stabilisers to work if an economic recovery fails to materialise in 2001. Nevertheless, measures to remove remaining distortions in the tax system and to improve the allocative efficiency of expenditure are important to cope with the cost of increased economic cooperation with North Korea and population ageing – the special topic in this year's *Economic Survey*. The demographic transition underway will undoubtedly have a major impact on public expenditures. While the ageing process is occurring relatively late in Korea, it is among the most rapid in the OECD area. Indeed, Korea's elderly dependency ratio, which is currently the third lowest in the OECD, is projected to be the sixth highest in 2050. This reflects the large drop in the birth rate – from over five in the 1950s to 1.5 in the

second half of the 1990s – and the largest gain in life expectancy in the OECD area over that period. The speed of the demographic transition will be complicated by the absence of a well-developed social safety net and the weakening of the traditional pattern of children caring for elderly parents. A second source of income for the elderly is the retirement allowance paid to departing employees, although it only covers 17 per cent of the working-age population and is actually a separation allowance. Given the traditional sources of income support and the hitherto relatively short life span, preparing for one's own retirement is a relatively new concept in Korea. ■

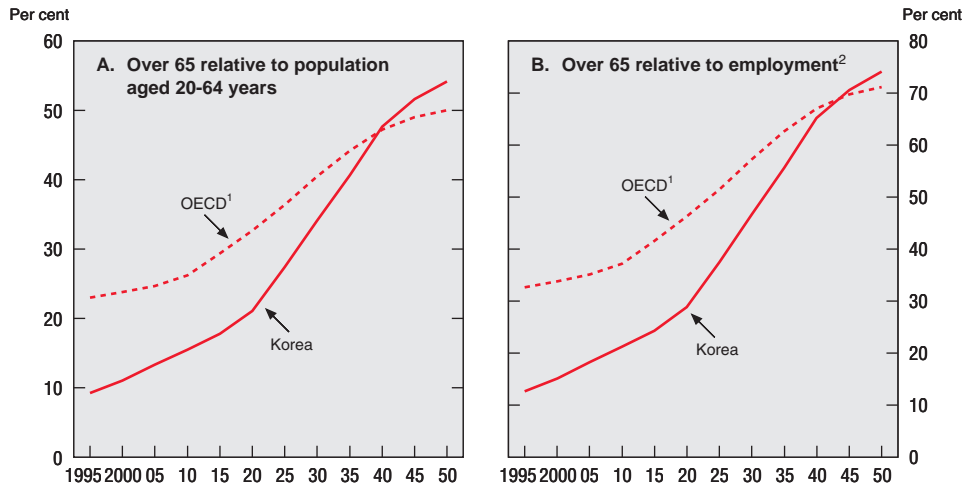
What reforms are needed to improve the system of support for the elderly?

To supplement private sources of support for the elderly, the government established the National Pension Scheme (NPS) in 1988. However, the current public pension system, which also includes occupational schemes for civil servants, the military and private-school teachers, has a number of weaknesses. *First*, it is projected that the contribution rate for the NPS will have to rise from the current 9 per cent to over 17 per cent during the next few decades to provide the average income worker with forty years of contributions a pension equal to 60 per cent of his or her average lifetime wage. Consequently, public

spending on pensions will rise by 8 percentage points of GDP, one of the largest increases projected among OECD countries. Combined with the retirement allowance, pension costs will exceed a quarter of the wage bill, with likely negative consequences for labour markets and potential growth. Moreover, this will impose a large burden on today's younger generation, which may well have to bear, in addition, the cost of national unification. *Second*, less than half of the labour force contributed to the NPS in 1999, reflecting a low level of participation among the self-employed. Moreover, the self-employed significantly under-report their income. The large rise in the contribution rate needed to sustain the NPS is likely to discourage greater participation. *Third*, total replacement rates are rather high, approaching 90 per cent for employees who receive retirement allowances. *Fourth*, the lack of linkages between the NPS and the occupational schemes limits labour mobility. *Fifth*, the concentration of assets in the National Pension Fund – which according to some estimates could rise to as much as 50 per cent of GDP under the current contribution rates – poses some risks.

Korea has a window of opportunity to overcome these weaknesses by systemic reform of the current system, since the NPS does not begin paying regular pensions until 2008. While the government is faced with many difficult restructuring issues, pension reform should be addressed now as it will become increasingly difficult as the current system matures. Pension reform should aim at increasing the role of private-

Korea's population is ageing rapidly



1. The average of the rates of individual countries (excluding Turkey and Mexico).
2. For the projections, the employment to population ratio is kept at its 1995 level.

Source: Eurostat for EU countries and United Nations for others.

sector savings for retirement and expanding coverage. In addition, it should limit contribution rates to around 15 per cent, as recommended by Korea's Pension Reform Task Force.

These goals could be accomplished by the establishment of a three-pillar system.

- The *first pillar*, a mandatory public pension, might consist of two parts. First, a tax-financed universal welfare pension, which would achieve the redistributive goals and overcome the problem of low participation. The second aspect of this pillar might be an earnings-related defined-benefit pension that is actuarially fair. It is important to ensure that the social welfare system adequately

covers the elderly until such a system is operational. The financial imbalances of the public occupational pension schemes, which are already in deficit, need to be addressed, and portability with the NPS introduced. Finally, the National Pension Fund should be operated in a way that promotes the development of long-term capital markets in Korea.

- The *second pillar* could be created by the conversion of the retirement allowance system into a mandatory corporate pension that is a fully-funded defined-contribution scheme. The allowance, which was created as a substitute for both unemployment insurance and a public pension system, has outlived its useful-

ness. Moreover, there is no requirement that the funds set aside for such payments be invested externally, thus making the allowances vulnerable to the financial health of the firm. Workers would benefit from the replacement of the current unfunded retirement allowance by a more secure source of retirement income. The corporate pension should be portable in order to promote labour mobility and allow participation by the self-employed.

- The *third pillar* would be a more effective system of individual pension accounts.

Health and nursing care are other areas where public expenditure is expected to rise with ageing. Korea has recently taken some bold steps

to change some aspects of its healthcare system, such as separating the prescription and sale of drugs and unifying the various health insurance systems into a nation-wide scheme. The effect of these reforms is as yet uncertain. However, it is important to ensure that the current system is efficient in order to limit the impact of ageing on expenditures. A number of options could be considered, including pre-funding of medical expenditures as well as the cost of long-term nursing care, a responsibility that has been mainly borne by families. Moreover, given the increasing participation of women in the labour force and the smaller number of children per family, the traditional pattern of elderly care will need to be supplemented by a larger government role. ■

Is the inflation-targeting framework appropriate?

Coping with ageing, as well as corporate and financial-sector restructuring, will be made easier by policies that promote growth over the long run. One crucial aspect is price stability. In this regard, it is essential to establish the credibility of the new inflation-targeting framework introduced in 1998. At the same time, the Bank of Korea was made independent and responsible for meeting the objective. Inflation in 1999 and 2000 came in below the central target, set at 3 and 2.5 per cent, respectively, as the appreciation of the won helped limit price increases. In 2001, the central objective was boosted by ½ percentage point to 3 per cent, plus or minus one percentage point. With the target measure –

the core consumer price index – up 4.3 per cent year-on-year during the first four months of 2001, inflation for the year is likely to be at the top end of the range.

The Bank of Korea has also switched from targeting monetary aggregates to an interest-rate based policy, although the impact of changes in short-term rates is particularly uncertain at present and probably somewhat limited in the context of significant restructuring of the financial sector. The overnight call rate has remained within 25 basis points of 5 per cent since 1998, with the most recent action being a 25 basis-point cut in July 2001. The current 4.75 per cent level implies that the real short-term rate is at a historically low level of less than 1 per cent. Since demand is still weak, interest rate hikes would be premature at this point. However, once a recovery is firmly established, the Bank of Korea should move promptly to raise interest rates to demonstrate its commitment to the 2.5 per cent medium-term inflation target. Given the long and variable time lags inherent in monetary policy, setting an annual inflation target is not useful, especially in the context of an interest rate-based policy. Finally, the continued use of “aggregate credit ceiling loans” provided to banks based on their lending to small and medium-sized enterprises seems inconsistent with the shift to an interest-rate based policy.

The exchange rate is taking a larger profile in monetary policy following the opening of the capital account and the adoption of a floating exchange rate in 1998. Given the rapid decline in the won in early 2001, the Bank of Korea

appeared to intervene in the exchange market to avoid any excessive overshooting of the currency. While the exchange rate should be closely monitored, given its influence on price developments, the effectiveness of sterilised foreign-exchange market intervention is likely to be limited in most cases. A floating exchange rate remains the best option, while encouraging companies and financial institutions to take foreign-exchange risks into account. ■

What policies are needed to promote competition?

In addition to low inflation, policies to enhance competition would sustain Korea's high growth potential. The Korea Fair Trade Commission and the Regulatory Reform Committee (RRC) have launched efforts to increase competition and reform regulations in specific industries. It is important that shareholders and financial institutions increase their monitoring of intra-chaebol activities. Further progress in these areas should allow an easing of regulations applied to the chaebol. This would enable the KFTC to devote more resources to traditional competition concerns. It is also crucial to maintain the momentum of the Regulatory Reform Committee in abolishing regulations that limit competition and in screening proposed legislation. Publication of the “Regulatory Impact Analysis” statements, which are required for proposed regulations, would help increase support for the reform process. In addition, the effort to

harmonise Korean standards with international norms should be carried out fully to ensure that standards do not act as impediments to imports. The trend towards reducing and streamlining government protection and support for small and medium-sized enterprises is welcome and should continue. In addition, ensuring labour mobility is essential to restructuring, while providing an adequate social safety net. The fact that only 11 per cent of the unemployed receive benefits makes restructuring more difficult. Moreover, the new social welfare programme introduced last year should be available to all those meeting the eligibility criteria and provide enough support to

bring income levels at least to the minimum cost of living.

Policies to boost competition have been accompanied by reforms in key sectors. However, the ten-year plan launched in 1999 to introduce competition into the *electricity sector* has fallen behind schedule. Implementing this plan, which includes the separation and privatisation of the publicly-owned generating and distribution facilities, would bring significant benefits to consumers. In the *telecommunications sector*, the government should also follow through on its plan to fully privatise Korea Telecom by June 2002. This measure, combined with steps to reduce government intervention in this

sector and to introduce an independent regulatory authority, would strengthen competition. In *agriculture*, the government is decreasing price supports, while expanding direct payments to farmers, as agreed in the Uruguay Round. The ultimate goal, though, should be to increase the efficiency of the agricultural sector, in part through boosting the size of farms. ■

For further information

Further information on the Survey can be obtained from Randall Jones, Tel.: (33-1) 45 24 79 28 (email: Randall.Jones@oecd.org). ■

For further reading

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OECD Headquarters
2, rue André-Pascal
75775 PARIS Cedex 16
Tel.: 33 (0) 1 45 24 81 81
Fax: 33 (0) 1 45 24 19 50
E-mail: sales@oecd.org
Internet: www.oecd.org

GERMANY

OECD BERLIN Centre
Albrechtstrasse 9/10
D-10117 BERLIN
Tel.: (49-30) 2888353
Fax: (49-30) 28883545
E-mail:
berlin.contact@oecd.org
Internet: www.oecd.org/deutschland

JAPAN

OECD TOKYO Centre
Landic Akasaka Bldg
2-3-4 Akasaka, Minato-Ku
TOKYO 107
Tel.: (81-3) 3586 2016
Fax: (81-3) 3584 7929
E-mail: center@oecdtokyo.org
Internet: www.oecdtokyo.org

MEXICO

OECD MEXICO Centre
Av. Presidente Mazaryk 526
Colonia: Polanco
C.P. 11560
Mexico, D.F.
Tel.: (00.52.5) 281 3810
Fax: (00.52.5) 280 0480
E-mail:
mexico.contact@oecd.org
Internet: www.rtn.net.mx/ocde

UNITED STATES

OECD WASHINGTON Center
2001 L Street N.W.,
Suite 650
WASHINGTON D.C. 20036-4922
Tel.: (1-202) 785 6323
Fax: (1-202) 785 0350
E-mail:
washington.contact@oecd.org
Internet: www.oecdwash.org
Toll free: (1-800) 456 6323

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