Assessment and recommendations

Korea has rebounded strongly from the global recession thanks to buoyant exports…

Korea has achieved one of the fastest recoveries in the OECD area from the global recession. Korea's trade-dependent economy had initially been hard hit by severe global financial distress in late 2008, leading to exceptionally sharp declines in exports and output. The recession was accompanied by financial turbulence that widened risk premia and tightened bank lending attitudes. Large capital outflows pushed down equity prices but the resulting depreciation of the won – by 25% in effective terms during the six months from August 2008 – combined with strong demand from China laid the foundation for an export-led recovery. Indeed, Korea became the ninth-largest exporter in the world in 2009, from 12th in 2008, and its current account surplus rose to 5% of GDP. Korea's strong recovery, together with its chairmanship of the G20 in 2010, have significantly raised its profile in the global economy.

… and a prompt and effective policy response

Fiscal and monetary policies, combined with measures to stabilise the financial sector, also played an important role. The government implemented the largest fiscal stimulus package among OECD countries, amounting to 6.1% of GDP, almost evenly split between additional expenditures and tax cuts. Increased spending boosted public investment and created nearly 300 thousand temporary public employment jobs in 2009, thus mitigating the upward pressure on unemployment and sustaining private consumption growth. Meanwhile, the Bank of Korea reduced its policy rate from 5¼ per cent in 2008 to a record-low 2% by February 2009, while introducing exceptional measures to increase liquidity to avoid a credit crunch. To reduce financial distress, the authorities used public money to recapitalise banks and purchase non-performing assets. Finally, public assistance to small and medium-sized enterprises (SMEs) was ratcheted up through increased government support and credit guarantees, as well as a range of other measures to support lending to small firms.

The expansion is projected to continue through 2011…

The expansion is projected to remain on track, with output growth of 5¾ per cent in 2010, easing slightly to 4¾ per cent in 2011. The recovery in world trade will sustain Korean exports, although some of the competitiveness gain from the won's decline has been offset by its appreciation over the past year. Nevertheless, the prospect of vigorous growth in China, which accounts for almost one-third of Korean exports, is a positive sign. The impact of buoyant exports will be increasingly evident in domestic demand, supporting business investment and employment. The permanent cuts in personal and corporate income tax rates in 2009-10 and improving household and business confidence will also bolster domestic demand, helping to reduce the current account surplus to below 2% of GDP. The main risks to the outlook are linked to the evolution of world trade and the exchange rate. Moreover, the high level of household debt might hold back consumption somewhat.

… allowing the phasing out of fiscal stimulus…

With vigorous output growth, government spending in 2010 is being appropriately reduced by 4% from the high level recorded in 2009 due to fiscal stimulus. In light of recent tax cuts, limiting the pace of expenditure growth is essential to achieve the medium-term fiscal target of reducing the consolidated central government budget deficit, excluding the social security surplus, from around 4% of GDP in 2009 to 0.5% in 2013. The target implies limiting spending growth from the 7% average annual pace recorded between 2004 and 2008 to around 4%. The recent reforms to the medium-term fiscal plan are expected to make it more effective in controlling spending. Even so, additional steps to make the spending targets more binding deserve to be explored. As in many other countries, the longer-term impact of population ageing should also be taken into account.

… which is important to keep public debt at a low level

Achieving this 2013 budget target would help limit gross government debt, currently at 35% of GDP, to less than 40%, far below the projected OECD average of 96% in 2010. Maintaining a low public debt burden is an important priority for Korea, given rapid population ageing and uncertainty about the eventual cost of greater economic integration with North Korea. Besides, the debt of public corporations increased sharply in recent years, from 10% of GDP in 2004 to 17% in 2008. To limit any possible fiscal burden, the growth should be kept in check, in part by subjecting public corporations to tighter financial control. In addition, moving ahead with the privatisation of the 18 public institutions identified in the 2008 plan would shrink the public enterprise sector.

It is time to start normalising interest rates

The central bank has scaled back the exceptional liquidity provisions introduced in the wake of the crisis. Nevertheless, considerable monetary stimulus remains in place, with the policy rate still at 2%, making it negative in real terms. Monetary conditions have tightened somewhat since early 2009 with the appreciation of the won, but they remain exceptionally relaxed, and are still close to the level they were in 1998 in the wake of the financial crisis. Inflation decelerated sharply from its 2008 peak of 5.5% (year-on-year), well above the Bank of Korea's target zone of 2% to 4%, to 2% in mid-2009. However, inflationary pressures are expected to build up, with private-sector employment increasing and the unemployment rate projected to fall below 3½ per cent in 2011. Therefore, given its outlook for strong output growth led by private-sector demand, the central bank should start to normalise interest rates to keep inflation expectations firmly anchored at their current level of 3%. Such pre-emptive action would avoid another run-up in inflation, which would likely require a significant tightening that could undermine the expansion. Finally, the flexible exchange rate policy has served Korea well and should be maintained.

Sustaining growth over the medium term requires reforms in the labour market to boost participation rates and…

While appropriate fiscal and monetary policies are essential to keep the upturn on track, measures to support Korea's growth potential are also a priority. Korea's per capita income rose to around two-thirds of the level in the more advanced OECD countries by 2008, thanks in part to an exceptionally large labour input. However, working hours are declining steadily and population ageing is projected to be the most rapid in the OECD area over the next 40 years. This prospect makes it all the more important to boost women's labour force participation, which is one of the lowest in the OECD area. A range of policies are needed to increase the availability and quality of childcare and make it more affordable, lengthen maternity leave and improve its coverage and encourage family-friendly workplaces that enable parents to combine work and family responsibilities. In addition, it is important to reduce the gender wage gap by moving away from a seniority-based wage system and giving more emphasis to performance. This would also encourage firms to keep older workers, as the current system makes them too expensive, resulting in their departure from firms before age 55 on average. Prohibiting companies from setting a mandatory retirement age and phasing out the lump-sum retirement payment in favour of company pensions would also help make more effective use of older workers.

… measures to reduce labour market dualism

Labour market reforms are also needed to reduce the high share of non-regular workers, who account for more than one-third of employees. Labour-market dualism reflects the rising share of temporary workers to 28% of employment, double the OECD average. Firms hire non-regular workers to increase labour flexibility, given the difficulty of dismissing regular workers, and to reduce labour costs, as wages for non-regular workers are significantly lower. Moreover, more than half of non-regular workers are not covered by employer-based social insurance systems, further cutting their cost to firms. Addressing the problem of labour market dualism requires a comprehensive approach that includes lowering employment protection for regular workers, expanding the coverage of non-regular workers by the social insurance system and improving training, including lifelong learning opportunities, to enhance their employment prospects. Reducing dualism, which is most prevalent among women, would also make the labour market more attractive to them, thus encouraging female employment. In addition, it would address the equity problem resulting from having such a large share of the population subject to precarious employment and significantly lower wages, while receiving less social insurance coverage. Finally, reducing dualism would encourage human capital formation, given that temporary workers receive less on-the-job training than permanent workers, thereby promoting the growth of labour productivity.

Increasing productivity, particularly in services, is a priority…

Labour productivity per hour worked in Korea is only half of that in the more advanced OECD countries, suggesting considerable scope for growth. The greatest potential lies in services, where productivity is only 58% of that in Korea's manufacturing sector, as well as in agriculture, where government support is among the highest in the OECD area. The government has appropriately attempted to shift the focus from manufacturing, which has driven Korea's rapid economic development during the past half-century, to services, notably by launching a major initiative in 2009. There has been progress in reducing entry barriers, notably by easing the minimum capital requirement, while international competition is being strengthened by including services in Korea's growing list of free-trade agreements. However, several aspects of the service initiative raise concerns. *First,* the inclusion of certain services on the list of "growth engines" could raise fiscal costs and lead to distortions in resource allocation. *Second,* levelling the playing field between services and manufacturing would be better achieved by reducing support to the latter, rather than, as planned, extending more government guarantees and payments to service firms, notably SMEs.

… through strengthening competition and R&D…

The government recognises that overly strict regulations obstruct investment and competition in services. Reform is particularly important in the following areas:

- Competition policy should be further upgraded by increasing financial penalties and phasing out the special treatment of SMEs, which play a dominant role in services.
- Regulatory reform should be accelerated, focusing on entry barriers. The time, cost and number of procedures to create a new firm, which are still above the OECD average, should be further reduced. In addition, the reforms introduced in the six Free Economic Zones should be extended to the rest of the country.
- The stock of inward foreign direct investment (FDI) as a share of GDP in Korea is among the lowest in the OECD area, as is the share of services in Korea's inward FDI. Foreign investors should be encouraged by reducing formal barriers, removing product market regulations and creating a more foreign investment-friendly business climate.

Finally, government R&D programmes should be more open and relevant to service firms, which account for only 7% of private-sector R&D, the lowest share in the OECD.

… and scaling back public support for SMEs

The problems in services are closely linked to those of SMEs, which account for more than 90% of service-sector employment. Extensive public support for SMEs has blunted competitive pressure, slowed reform and reduced the efficiency of resource allocation. In 2009, to prevent chain bankruptcies and minimise systemic risk, the government increased assistance to SMEs by: *i)* sharply raising guarantees by public financial institutions for lending to SMEs; *ii)* advising banks to automatically roll over loans to SMEs (excluding those already delinquent on existing loans); *iii)* creating two initiatives to aid SMEs in distress; and *iv)* doubling government spending to assist SMEs. Moreover, government assistance to banks, such as guarantees on their foreign borrowing and capital injections, were contingent on increased lending to SMEs.

While expanded financial support to SMEs has prevented some bankruptcies and helped to sustain employment, it has also exacerbated moral hazard problems by increasing the reliance of SMEs and banks on public assistance. With the economic recovery in place, the government has started to scale back support. It is essential to speed up the phasing out of this assistance – particularly the automatic rollover of loans and expanded loan guarantees – and to promote the restructuring of SMEs. Supporting non-viable firms will act as a drag on Korea's growth potential.

While the financial sector has weathered the crisis well…

The health of the SME sector has important implications for the banking sector, given that it accounts for about one-half of banks' lending. Banks have thus far weathered the crisis relatively well, thanks to their initially strong position and an effective policy response. The authorities provided injections of public capital amounting to 0.4% of GDP into eight financial institutions and purchased non-performing assets for an additional 0.3% of GDP. In addition, the supervisors took measures, allowed within the framework of Basel I, to boost banks' reported capital, thus enhancing their lending capacity.

… further reforms are needed to address weaknesses…

While the banks appear sound at present, it will be important to monitor them closely, particularly as non-performing loans could increase as support for SMEs is scaled back. Moreover, reforms are needed in a number of areas. *First,* it is important to upgrade the governance of financial institutions in line with the guidance of the Basel Committee on Banking Supervision, which follows the OECD principles. *Second,* the reliance on credit rating agencies in financial regulation should be reduced, while enhancing the accountability of the agencies. *Third,* while developing securitisation would increase efficiency in the financial sector, the global financial crisis shows the need for measures to enhance the transparency of securitised products and trading rules so as to reduce the risks. *Fourth,* fostering financial institutions that would be large by international standards could create concerns, given recent experience in a number of countries. The efficiency gains from large institutions appear to be small, while the moral hazard associated with "too big to fail" can be severe.

… while reducing vulnerability to sudden capital outflows…

In addition, reforms are needed to limit the risk of sudden capital outflows. As an export-oriented and non-reserve currency country with an open capital account, Korea is relatively sensitive to external shocks, even in 2008 when it had the world's sixth-largest foreign exchange reserves and its economy and financial sector were relatively strong. It is important to continue building a transparent and sound financial system that would help maintain investors' confidence and better absorb shocks from abroad. In particular, foreign investors' concern about Korea was linked to the rise in external borrowing by the banks and the mismatch in maturities of their assets and liabilities. The planned measures to reduce foreign exchange risks, in part through the revision of the regulation on foreign currency liquidity, are an important step. Additional measures to further internalise the risk of foreign borrowing by financial institutions to provide incentives for them to monitor this source of funds more carefully would be welcome. For example, deposit insurance premiums could be adjusted on the basis of banks' foreign borrowing. Given the important role of foreign bank branches in increasing Korea's external borrowing, it would also be helpful to expand Korea's ability to supervise those branches, based on an agreed international framework. Finally, Korea's bilateral currency swaps announced in late 2008, in addition to its large stock of foreign exchange reserves, helped it overcome the recent crisis. Such swaps, perhaps supplemented by a more formal multilateral framework, remain a useful tool to cope with any future crises. In particular, it is preferable to the more costly option of further building up Korea's already large foreign exchange reserves.

… and the risks associated with mortgage lending

Another important risk is related to mortgage lending, which played a pivotal role in the 2008 global crisis. Korea managed to avoid a housing bubble, in part due to a regulation limiting mortgage loans to 40% of the value of a property in some parts of the country. Nevertheless, there is chronic concern in Korea about rising housing prices in the capital region, reflecting strong demand driven by economies of agglomeration and the educational opportunities in the capital, coupled with restrictions on new construction in the region, designed to limit the concentration of the population. The government should phase out the various policies used in recent years to control housing prices, such as price controls on new housing, and rely on appropriate loan-to-value (LTV) and debt-to-income (DTI) ratios to limit risks to financial institutions. In addition, it should avoid frequent changes in these ratios, which were relaxed in late 2008 and then tightened in 2009, to foster price stability. Finally, a longer-term solution to concern about housing prices would be to relax regulations, including in the capital region, with a view to increase the supply of housing.

Reform of the health-care system is important to limit costs,…

Another area for reform is the rapidly growing health-care sector, which has contributed to the marked improvement in the health status of Koreans. Although health spending as a share of GDP in Korea was the third lowest in the OECD area in 2008 and only one-half is financed by the public sector, health spending – both the total and the public share – has been rising at double-digit rates since 1995. Moreover, rapid population ageing and the plans to expand the range of services covered by the National Health Insurance (NHI) will lead to substantial increases in the years ahead. Improving the efficiency in supplying health services will ease the impact on public spending and the need for higher government revenue, thereby limiting the burden on households. Priorities for reform include:

- The fee-for-service payment system, which contributes to long hospital stays and the highest number of physician consultations in the OECD area, should be shifted to a Diagnostic-Related Group (DRG) approach for in-patient care. The DRG has been found to reduce unnecessary treatment and the length of hospital stays in Korea. For out-patient care, some form of capitation would help reduce the incentive for frequent and short appointments with physicians.

- Expenditures on pharmaceutical drugs could be reduced by cutting the average number of drugs per prescription from more than four at present to as low as two, as in some OECD countries. Savings could also be achieved by changing the pricing system for drugs, cracking down on illegal rebates by pharmaceutical manufacturers and letting the price of generic drugs fall. Gradually removing the regulation that requires non-prescription drugs to be sold only in pharmacies would also reduce drug prices by enhancing competition.
- The long average stay in hospitals is partly a result of their role in providing long-term care to the elderly. The introduction of long-term care insurance in 2008 provides an opportunity to shift such treatment to less-expensive home-based care or long-term care facilities.
- It is important to promote healthy ageing to limit health-care costs as the population ages. The priority is to raise the exceptionally low tax on cigarettes to reduce the high smoking rate of men.
- Introducing a gatekeeper system would favour less expensive and more effective primary care. This would require increasing the number of physicians who are general practitioners.

… to finance health spending efficiently,…

Even with such reforms, spending on health will rise significantly in the future, making it important to finance it in the least distortive manner possible. Increasing the already high co-payment rates, which range from 20% for in-patient care to 30% to 60% for out-patient care, is not an option. Given the already high level of private spending on health care, relying mainly on private insurance to finance the increase in health spending would not be appropriate. Consequently, funding will have to come primarily from social insurance payments, which finance most of public health spending at present, and tax revenue. Tax-based financing, which is currently low, could be increased over time, in conjunction with effective measures to keep spending in check. Continuing to rely primarily on social insurance payments levied on wage income to finance growing health spending would progressively increase the labour-market tax wedge and thus hold back employment and growth. This negative effect would become stronger as population ageing reduces the number of persons between the ages of 20 and 64 from more than six per elderly person at present to only 1.3 by 2050. Broadening the base of financing for health care would mitigate the disincentives for work, especially if the revenue were raised through indirect taxes. More reliance on tax-financing would also ease the problem of the large and growing gap between the social insurance payments by employees and the self-employed, who account for one-third of the labour force. Nevertheless, it is essential to improve the compliance of the self-employed with social insurance payments and income taxes to promote horizontal equity.

… to ensure adequate access to health care…

Out-of-pocket payments, for co-payments and services not covered by the NHI, accounted for 4.6% of household final consumption in 2007, the third highest in the OECD area. For low-income households, the share of such payments in income is about four times greater than for households with average income. High out-of-pocket payments are inequitable and they reduce necessary, as well as unnecessary, health treatments. Korea introduced a ceiling on co-payments in 2004 and revised it in 2009 to make it depend on the level of social insurance payments to the NHI. Nevertheless, the permitted ceiling for co-payments remains high for low-income households, thus falling short in terms of risk protection. A second concern related to access is the shortage of physicians in certain medical specialties. Resolving such imbalances requires improving the annual fee-setting process so as to better equilibrate supply and demand, rather than the usual practice of granting uniform fee increases across-the-board.

… and to improve the quality of health care

Aside from high costs, the major complaint of patients concerns the quality of health care. Providing more information on patient outcomes would encourage quality competition among providers, thereby improving quality. In addition, expanding the pilot project that bases 10% of NHI reimbursements of hospitals on quality evaluations would also be beneficial, as much of the dissatisfaction about quality centres on hospitals. While only physicians and non-profit corporations are allowed to establish hospitals, they act as for-profit institutions in practice. However, their non-profit status limits their financing options. Allowing investor-owned hospitals would stimulate competition and may thus improve the quality of care. In addition, allowing mergers and acquisitions between hospitals would be beneficial. Another major complaint concerns waiting times for treatment. The government needs to raise the ceiling on the annual number of new medical students to boost the number of physicians, which at 1.7 per 1 000 population, is one of the lowest in the OECD.

Addressing the challenge of climate change…

Korea's long-term prospects will depend on how it responds to the challenge of climate change. In 2008, the President proclaimed "Low Carbon/Green Growth" as the vision to guide Korea's development during the next 50 years and in 2009 introduced the National Strategy for Green Growth to: *i)* mitigate climate change and promote energy independence; *ii)* create new engines for economic growth; and *iii)* improve the quality of life. In 2009, Korea voluntarily set a goal of cutting its greenhouse gas emissions by 30% relative to a "business as usual" baseline by 2020, which implies a 4% reduction relative to 2005. Meeting this target will be challenging, as emissions almost doubled between 1990 and 2005, making Korea one of the fastest-growing source of emissions in the OECD area. Moreover, Korea has one of the highest levels of energy intensity in the OECD area, reflecting its concentration in energy-intensive industries. Korea has thus far relied primarily on voluntary commitments by firms to reduce emissions.

… requires market instruments that set a price on carbon…

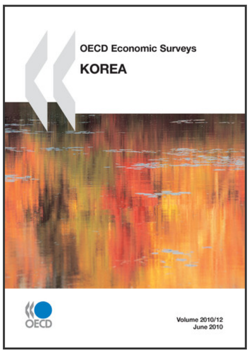
Achieving the 2020 target in a cost-effective manner requires improving the policy framework by introducing market-based instruments to reduce emissions. Market instruments are efficient as they equalise abatement costs across all emitters and, over the long run, provide incentives to develop new technologies that lower abatement costs. Korea is considering the introduction of an emissions trading system (ETS), although no date has yet been set. It is important to move ahead quickly with a nation-wide ETS based on cap-and-trade, ideally with the initial permits allocated by auctioning. The ETS should be extended to as many sectors as possible, while introducing a carbon tax in other sectors. The system should include banking of permits and possibly borrowing as well, to limit risk, uncertainty and volatility. At the same time, it is important to remove subsidies for fuel-based energy production and consumption.

… while limiting distortions in policies to promote green industry…

The government launched the Five-Year Plan for Green Growth for the period 2009-13, which calls for spending 107 trillion won or 2% of GDP per year. The large amount reflects the inclusion of major infrastructure projects, such as the "Four Major Rivers Restoration Project" and the expansion of the high-speed train network. It also includes 23 trillion (2.2% of 2009 GDP) for securing new growth engines. Part of this amount will be used for "green finance", which will involve government lending and credit guarantees. Green finance also includes tax incentives for financial instruments that invest in firms and technologies that have been granted "green certificates" by public institutions. It is important to avoid the risk that the green finance project might fuel a bubble, as occurred when the government tried to jump-start the venture business sector in the late 1990s. More generally, direct government support for green industries raises a number of policy challenges, given the difficulty of picking winners and the risk of being locked into the wrong technology.

… by focusing on basic R&D and framework conditions

The Five-Year Plan also includes 13 trillion won (1.2% of GDP) in R&D focused on 27 core technologies. Given that price signals alone do not ensure adequate R&D and innovation, especially in the area of climate change, there is an important role for public R&D, particularly in basic research. Improving Korea's innovation framework would enhance its success in green R&D. However, in the absence of an appropriate price for carbon, it will be difficult to jump-start private innovation, thus underlining the need for the early introduction of an ETS. Finally, it is important to have good framework conditions, including flexibility to promote the redeployment of labour and capital from energy-intensive to green industries and openness to foreign competition.



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