

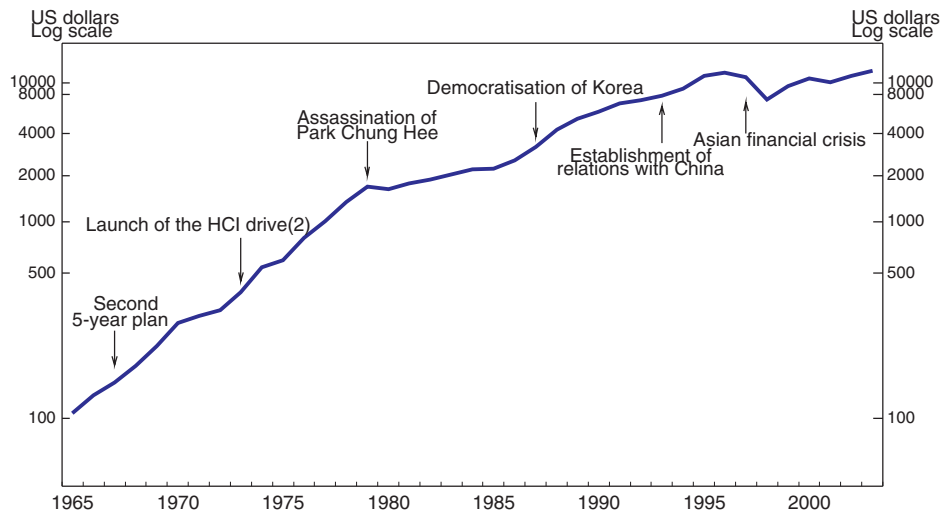
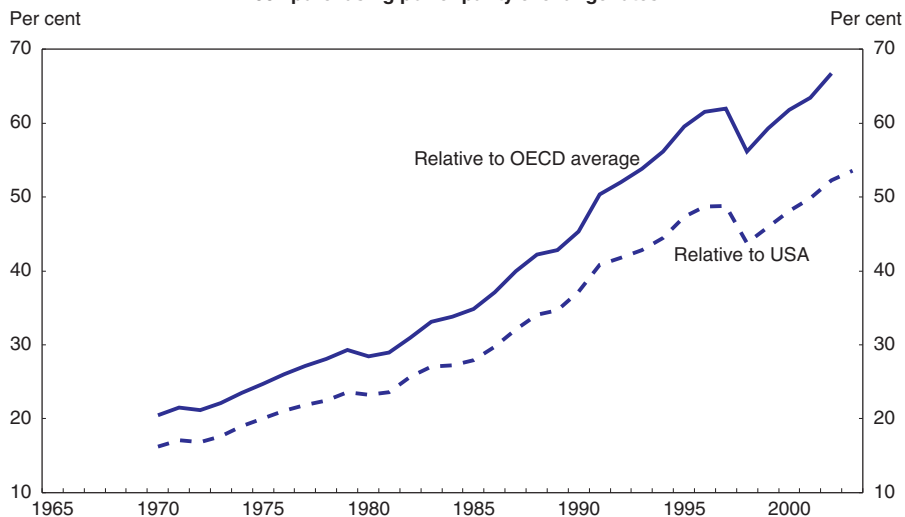
1. Becoming a high-income OECD country: key economic challenges

In July 2003, the government announced a medium to long-term target of doubling per capita income from around \$10 000 to \$20 000.¹ Thirty years of extraordinary growth had boosted per capita income from about \$100 in 1965 to the \$10 000 level by the mid-1990s (Figure 1.1). However, weaknesses in Korea's economic structure, which lacked many of the basic elements of a market economy, left the country vulnerable to the financial crisis that swept through Asia in 1997, reducing per capita income by a third in US dollar terms, primarily due to the sharp fall in the exchange rate. In particular, close government-business links had created moral hazard problems, resulting in excessive risk-taking and insufficient attention to credit and exchange-rate risks. The government responded to the crisis, as discussed in previous OECD *Economic Surveys of Korea*, by introducing a wide-ranging programme of reforms in the corporate and financial sectors and in the labour market to create a more market-oriented economy. The economy rebounded with an annual average growth rate of 6 per cent over the past five years. Adjusted for price differences, per capita income has risen to two-thirds of the OECD average (Panel B).

There are a number of challenges to maintaining a high rate of growth. *First*, growth has relied heavily on inputs of labour and capital, which are likely to slow in the future. If the contribution to growth from labour productivity were to maintain its level of the past decade, the pace of economic growth over the next five years would slow to about 4½ per cent. *Second*, structural weaknesses, reflected in the problems that pushed the economy into recession during the first half of 2003, illustrate the difficulty of sustaining rapid growth. While the economy was negatively affected by external factors, such as the SARS epidemic and the North Korean nuclear issue, a series of negative domestic shocks also undermined business and household confidence, more than offsetting the positive impact of 16 per cent growth of exports in volume terms (see Chapter 2). In particular, the SK Global scandal created renewed concern about the health of the corporate sector, while the financial sector was troubled by the problems of the credit card companies. Meanwhile, contentious worker-management relations resulted in labour strikes and unrest. These problems have been

Figure 1.1. Per capita income in Korea¹

A. Gross national income per capita in US dollars

B. Gross domestic product per capita
2002 purchasing power parity exchange rates

1. In March 2004, the Bank of Korea announced revised national accounts based on 1993 SNA for the period 1995 to 2003. This results in a sharp rise in per capita income in 1995.

2. Heavy and chemical industry.

Source: OECD.

compounded by unsettled political conditions. In short, this indicates that, despite recent progress, the reform agenda remains unfinished. This chapter begins by considering Korea's growth potential before discussing a number of obstacles to maintaining growth at a high level. These include the fiscal challenges associated with population ageing and eventual economic integration with the North, difficult labour market issues, problems in the corporate and financial sectors and weak competitive pressures in some parts of the economy. The chapter concludes with a brief assessment.

Korea's growth performance during the last decade

During the decade 1992 to 2002, Korea's output growth averaged 5.6 per cent a year, well above the 3 per cent rate recorded in the OECD area (Table 1.1). The most important factor was the increase of *labour productivity* at an average annual rate of 4¼ per cent, double the OECD average. Rapid productivity growth can be attributed, in part, to a high level of investment by the business sector. Although business investment as a share of GDP has fallen by a third since the 1997 crisis, it still remains the highest in the OECD area. Consequently, the level of fixed capital per worker has risen by more than two-thirds over the past decade, contributing to the strong labour productivity gains. Using a growth accounting framework, a recent study (Han *et. al*, 2002) estimated that capital inputs accounted for one-half of potential economic growth in the 1990s (Table 1.2).² A second factor has been the adoption of new technology, enabling Korea to continue its convergence to income levels in high-income countries. Korea's extensive use of foreign technology is illustrated by the fact that its deficit in the "technology balance of payments" is the second largest in the OECD area at 0.6 per cent of GDP.³ High growth over the past decade is also explained by the expansion of *labour inputs*, which accounted for about 1¼ percentage points of growth. Increased labour inputs reflect the increase in the working-age population and the upward trend in the participation rate. These two factors have more than offset a modest decline in working hours and a small rise in the unemployment rate.

The OECD's study of economic growth (OECD, 2003e) identified a number of keys to growth, including boosting investment in physical capital, upgrading skills and human capital, encouraging innovation, removing barriers to trade and investment, stimulating firm creation, improving the regulatory environment, and strengthening the economic and social fundamentals. As noted above, fixed investment in Korea is exceptionally high. The following section discusses Korea's progress in upgrading skills and human capital and encouraging innovation, while becoming more open to foreign competition by reducing barriers to trade and investment.

Table I.1. Sources of growth over the decade 1992 to 2002

Annual average

GDP growth	Labour productivity growth (output per hour)	Labour input growth (hours worked)	Contribution to labour input growth (percentage points)								
			Working-age population		Participation rate		Unemployment rate		Hours worked per person		
			Contribution	Level ¹	Contribution	Level ²	Contribution	Level ³	Contribution	Level ³	
Korea ⁴	5.6	4.3	1.3	1.1	71.5	0.5	67.1	-0.1	3.1	-0.3	2 410
Australia	3.9	1.9	2.0	1.2	67.1	0.3	75.8	0.4	6.3	0.0	1 837
Belgium	2.0	1.9	0.2	0.1	65.9	0.6	66.7	0.0	7.3	-0.6	1 528
Canada	3.6	1.5	2.0	1.2	67.6	0.3	78.6	0.4	7.6	0.1	1 783
Denmark	2.4	2.3	0.2	0.2	66.4	-0.2	80.4	0.4	4.5	-0.2	1 472
Finland	3.3	3.0	0.3	0.3	66.9	0.2	74.8	0.3	9.1	-0.4	1 685
France	2.0	1.9	0.1	0.3	65.0	0.5	70.1	0.1	9.0	-0.8	1 514
Germany	1.3	1.9	-0.6	0.0	67.3	0.4	76.1	-0.2	8.1	-0.8	1 459
Greece	2.7	2.2	0.5	0.3	63.5	0.5	63.7	-0.1	10.0	-0.1	1 922
Iceland	3.3	2.0	1.2	1.1	65.3	0.1	86.2	0.1	3.3	-0.1	1 838
Ireland	8.0	4.6	3.2	1.8	67.7	1.2	70.0	1.2	4.4	-1.0	1 674
Italy	1.6	1.6	0.1	0.0	67.5	0.3	61.3	0.0	9.1	-0.2	1 601
Japan	1.0	2.1	-1.0	-0.1	67.7	0.2	77.5	-0.3	5.4	-0.8	1 815
Netherlands	2.7	1.6	1.5	0.4	67.7	1.2	67.0	0.3	2.3	-0.4	1 333
New Zealand	3.6	1.1	2.5	1.4	75.4	0.5	76.4	0.6	5.2	0.0	1 818
Norway	3.3	2.6	0.7	0.6	65.1	0.5	80.4	0.2	4.0	-0.6	1 357
Spain	2.8	0.4	2.4	0.6	66.9	1.6	67.6	0.2	11.4	0.0	1 816
Sweden	2.6	2.3	0.2	0.4	64.7	-0.5	76.5	0.1	4.0	0.2	1 577
Switzerland	1.1	0.9	0.1	0.5	67.6	-0.1	87.3	0.0	3.1	-0.2	1 568
United Kingdom	2.9	2.2	0.7	0.3	65.2	0.0	75.6	0.5	5.2	-0.1	1 707
United States	3.2	1.6	1.4	1.2	75.4	0.0	75.3	0.2	5.8	0.0	1 819
EU average	2.9	2.2	0.7	0.4	66.2	0.5	70.9	0.2	7.7	-0.4	1 607
OECD average	3.0	2.1	0.9	0.6	67.5	0.4	71.0	0.2	6.9	-0.3	1 693

1. As per cent of total population in 2002.

2. Persons in the labour force divided by the working-age population in 2002.

3. In 2002.

4. Based on SNA 68. In March 2003, the Korean authorities announced national accounts on an SNA 93 basis for 1995 to 2003. However, to maintain a consistent series, the SNA 68 national accounts are used.

Source: OECD.

Table 1.2. **Korea's potential growth rate**
Annual average contribution in percentage points

	Potential growth	Labour	Physical capital	Total factor productivity	of which: Human capital
1981-1990	7.8	1.7	3.6	2.5	0.8
1991-2000	6.3	1.2	3.2	1.9	0.9
2003-2012					
Scenario A ¹	4.6	0.6	1.9	2.1	0.6
Scenario B ²	5.2	0.6	2.0	2.6	0.6

1. Assumes that Korea's economic system and international openness remain at the current level.

2. Assumes that Korea's economic system is improved through structural reform and increased international openness.

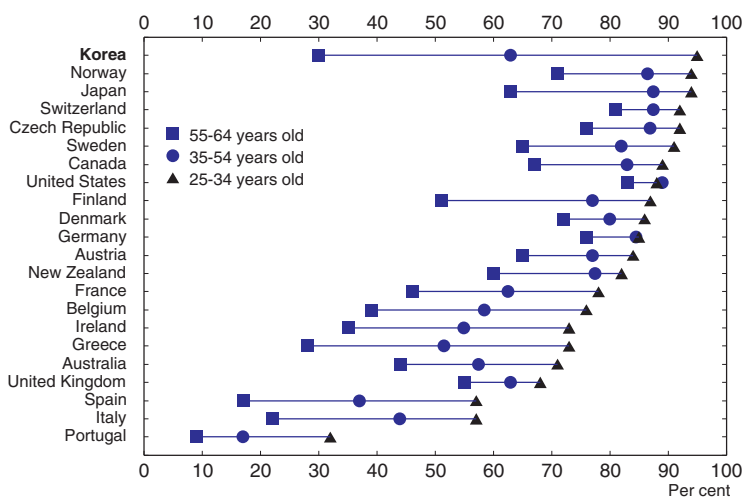
Source: Han *et al.* (2002).

Investing in knowledge

Korea has a high level of investment in knowledge, measured as expenditure on education and R&D outlays. Although public outlays on educational institutions are below the mean in the OECD area, private spending as a share of GDP is the highest. Consequently, total spending, at 7.1 per cent of GDP in 2000, is also the highest in the OECD area,⁴ thus helping to finance the rapid development of the education system both in terms of quantity and quality (see the 2003 *Survey*). While the proportion of older people (aged 55 to 64) with at least an upper-secondary qualification is low, the share for young adults between the ages of 25 and 34 is the highest among OECD countries (Figure 1.2). The expansion of education has upgraded the skill level of the labour force; the proportion of workers with less than a secondary-school degree fell from 39 per cent a decade ago to under 29 per cent, while the share with a university degree has risen from 18 to 27 per cent (Table 1.3). The rising number of years of schooling is estimated to have added 0.7 percentage point to economic growth each year during the decade from 1993 (Panel B). The quantitative expansion of the educational system has been accomplished while maintaining outstanding levels of student achievement. In international tests of 15-year-old students in science, reading and math in 2000, Korea ranked among the top three countries in each subject. The education system emphasises science and engineering, which account for 40 per cent of new university degrees, the highest proportion in the OECD.

Korea also devotes a relatively large share of national income to R&D investment. By 2001, it had reached 2.9 per cent of GDP, the fifth highest in the OECD area (Figure 1.3), with an exceptionally large share funded and undertaken by the business sector (Panel B). The emphasis on R&D has resulted in a 25 per cent annual average increase in Korea's applications at the European Patent Office during the 1990s, the highest growth rate among OECD countries. The information

Figure 1.2. **Share of the population with at least an upper-secondary qualification**
Per cent in 2001



Source: OECD.

Table 1.3. **Educational attainment and economic growth**
A. Highest level of education classified by gender, per cent of employed persons

		1993 ¹	2002 ¹	2012 ²
Lower than secondary degree	Men	31.9	22.9	14.9
	Women	50.4	37.5	23.9
	Total	39.4	28.9	18.7
Secondary school degree	Men	45.8	47.0	49.5
	Women	37.9	40.8	48.6
	Total	42.6	44.4	49.1
University degree or higher	Men	22.2	30.2	35.5
	Women	11.6	21.7	27.5
	Total	18.0	26.6	32.1

B. Impact on growth

	1993-97	1998-02	2003-07	2008-12	1993-02	2003-12
Growth of human capital index (%) ³	0.95	1.10	1.05	0.90	1.02	0.98
Contribution to economic growth ⁴	0.62	0.72	0.68	0.59	0.67	0.64

1. Data from Korea National Statistical Office.

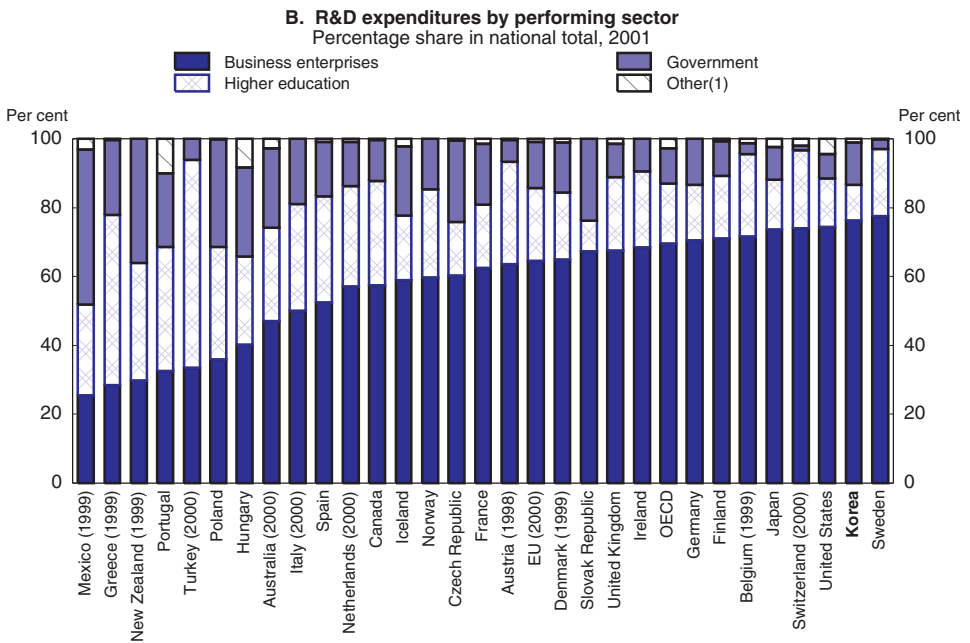
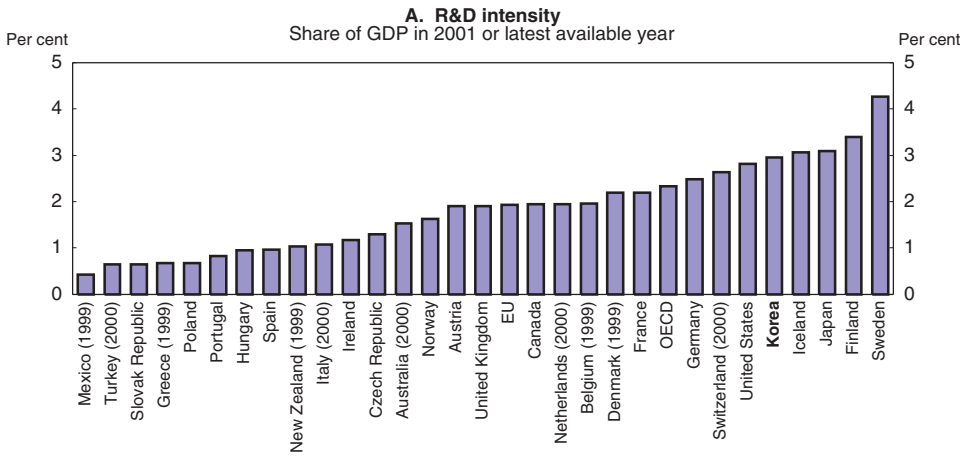
2. Projections by Han *et al.* (2002).

3. The human capital index is calculated based on the educational attainment of each age group and gender.

4. Percentage points.

Source: Han *et al.* (2002)

Figure 1.3. R&D expenditure



1. Private non-profit or not classifiable.
Source: OECD.

and communication technology (ICT) sector accounts for more than half of total R&D in the manufacturing sector.⁵ Another aspect of investment in knowledge has been the rapid development of Internet connections. In 2002, the broadband penetration rate was the highest in the OECD area, while the price of Internet access was the lowest (Figure 1.4).

The priority attached to R&D and investment in human capital underpins the key role played by new industries in Korea. Industries classified as high and medium-high technology manufactures accounted for nearly 14 per cent of gross value added in 2000, the second highest share after Ireland (Figure 1.5). This reflects Korea's specialisation in ICT products, which account for nearly one-fifth of manufacturing output. Despite a significant contraction in 2001, ICT exports amount to nearly a third of total exports, the second highest proportion among OECD countries.

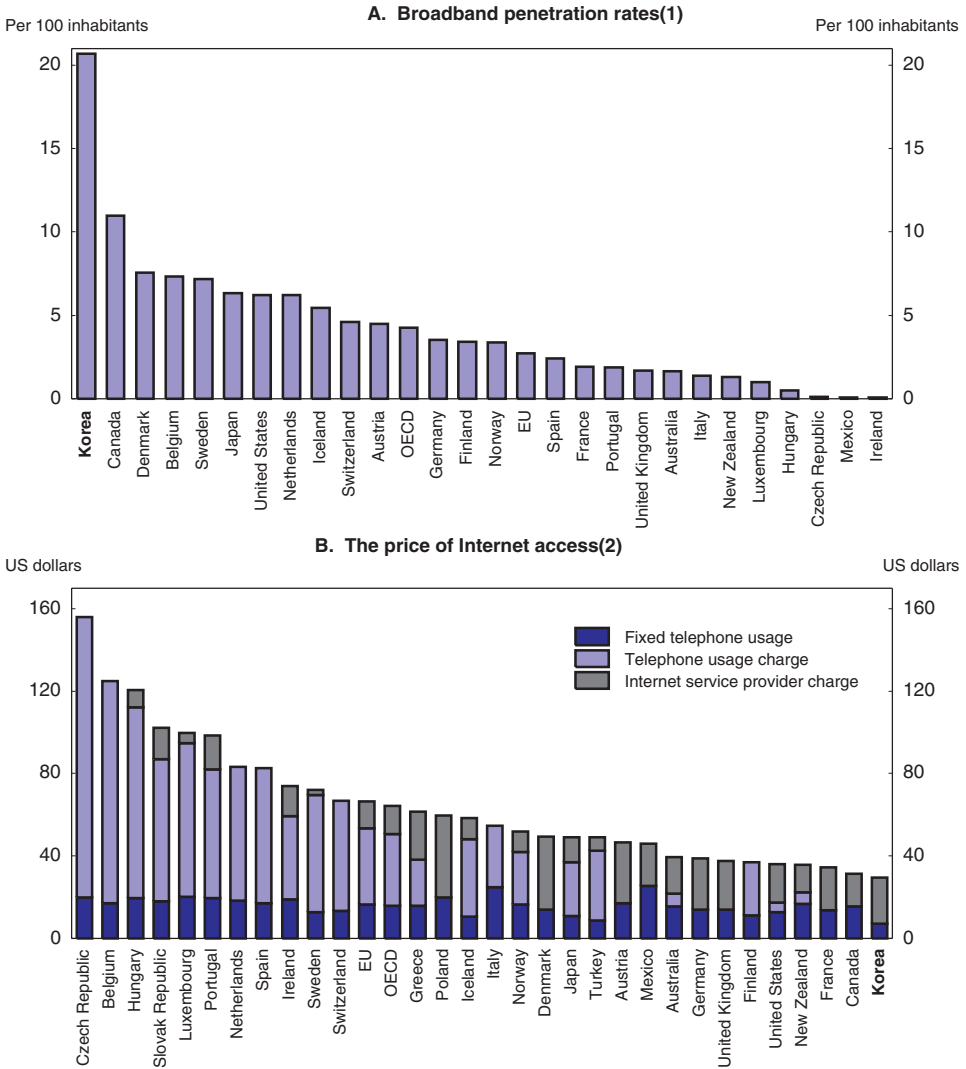
Increasing openness to international competition

Korea's strengths in technology-intensive products have boosted the importance of international trade in its economy. Indeed, world trade in high-technology products has nearly doubled during the past decade, outpacing the 50 per cent rise recorded for all manufactures. In addition, a reduction in Korea's import barriers has expanded trade. Perhaps most important was the phasing out by 1999 of the Import Diversification Programme, which had restricted imports of 924 items from Japan at its peak. All of this has helped to boost the share of international trade (the average of exports and imports) in the Korean economy from 25 per cent in 1993 to nearly 40 per cent at the start of the new century (Figure 1.6). An increase in inflows of foreign direct investment (FDI) following the 1997 crisis doubled the stock of FDI by 1999. Increased inflows reflected a change in the traditionally hostile attitude toward FDI inflows, the easing of restrictions and the urgency of corporate restructuring.

Korea's medium-term growth prospects

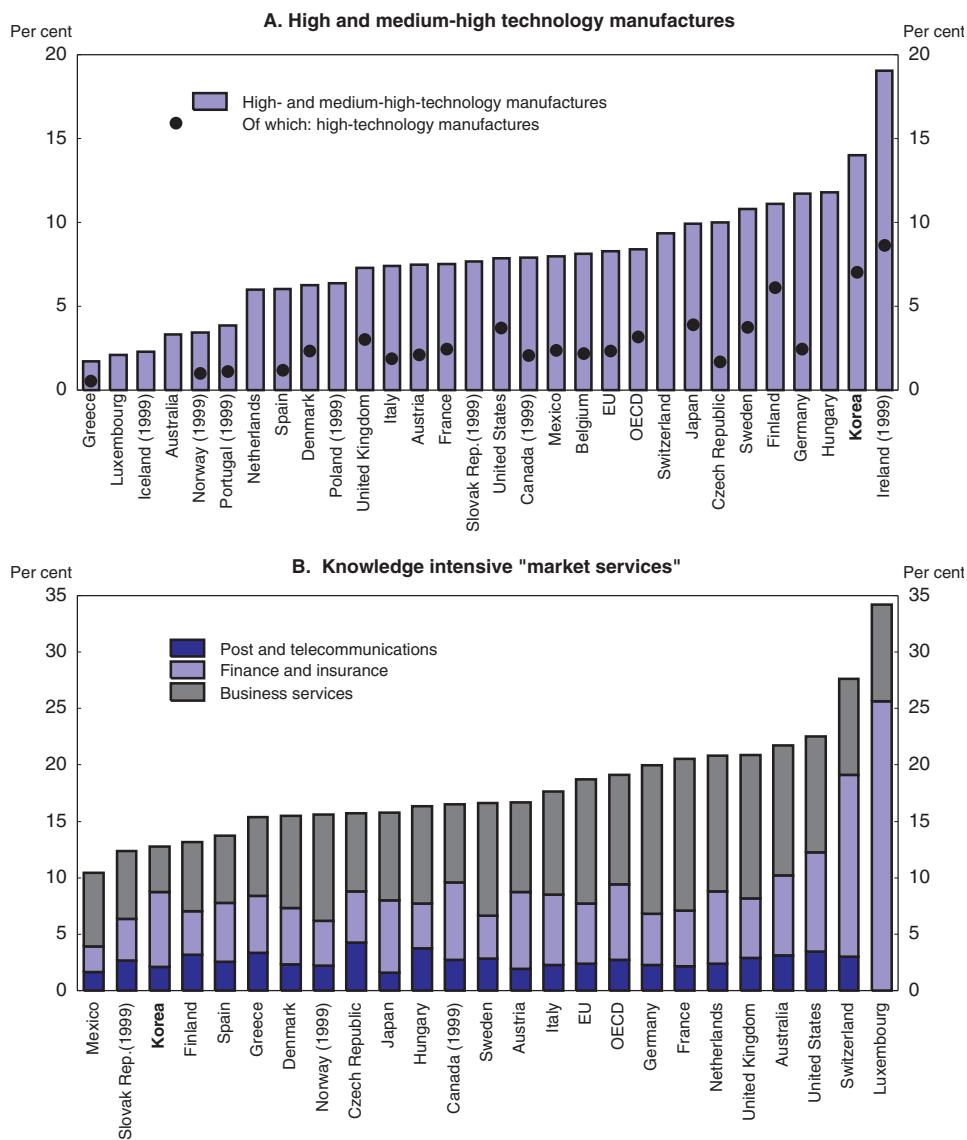
The large remaining gap in per capita income between Korea and the OECD average indicates considerable scope for rapid growth to narrow the difference (Figure 1.1). With a per capita income level at 67 per cent of the OECD average, Korea ranks in the bottom quartile of OECD countries by this criterion, along with Mexico and the Central European countries. The difference in labour productivity levels is even greater, given the exceptionally large input of labour in Korea. Indeed, labour input relative to total population in Korea is 21 per cent above the OECD average (Figure 1.7). The large labour input is primarily due to the fact that working time, at more than 2 400 hours per year, is the longest in the OECD area (Table 1.1). In addition, the unemployment rate is exceptionally low,⁶ at around 3 per cent, while the proportion of the population that is of working age

Figure 1.4. **Internet access and its price**
September 2002



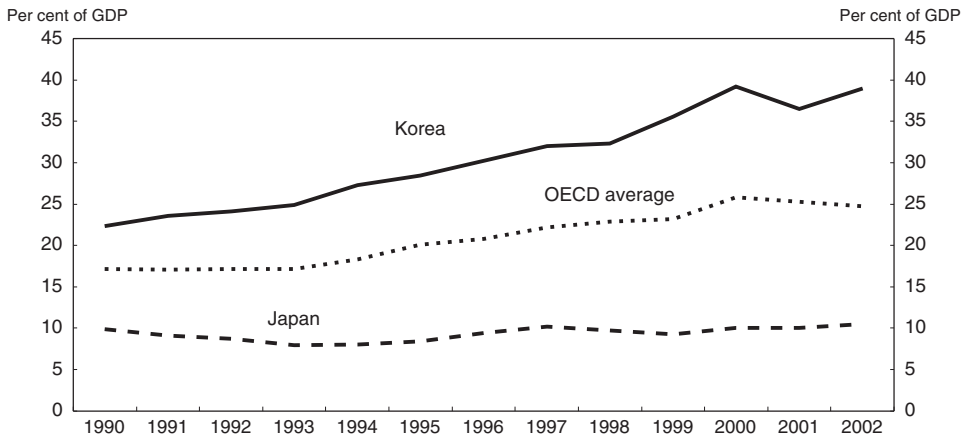
1. Number of digital subscriber lines, cable modem and other broadband connection lines per 100 inhabitants.
 2. OECD Internet access basket for 40 hours of daytime discounted PSTN (Public Switch Telecommunications Network) rates, including VAT, in US dollars, converted using PPP exchange rates.
 Source: OECD Science, Technology and Industry Scoreboard, 2003.

Figure 1.5. **Technology and knowledge-intensive industries**
Share of total gross value added in 2000



Source: OECD Science, Technology and Industry Scoreboard, 2003.

Figure 1.6. **Openness to international trade**
Trade in goods and services as a share of GDP¹



1. Average of exports and imports on a national accounts basis. In March 2003, the Bank of Korea announced revised national accounts based on 1993 SNA for the period 1995 to 2003. This results in a substantial increase in the ratio in 1995.

Source: OECD.

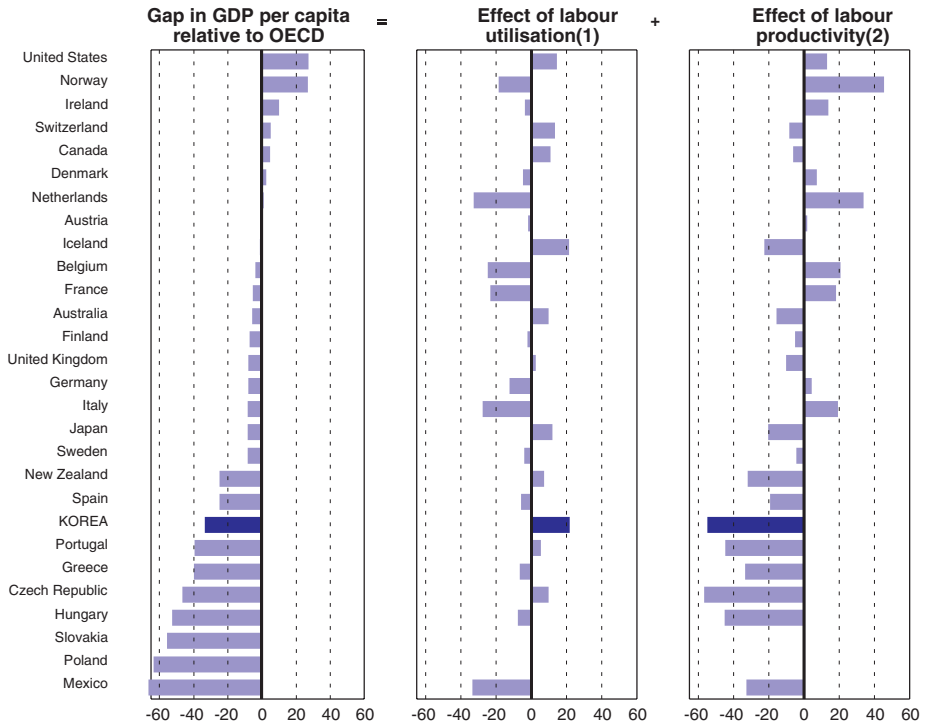
is relatively high, reflecting the comparatively young population. The effect of these factors on labour input more than compensates for the low labour force participation rate that is mainly due to a smaller proportion of women who work. Taking account of the higher level of labour inputs, labour productivity per hour worked was about half of the OECD average in 2002.

In addition to abundant labour inputs, capital inputs have also been exceptionally high as noted above, accounting for about half of potential growth during the 1990s, according to Han *et al.* (2002). A high level of domestic saving has been available to fund this investment. In sum, economic development has been input-intensive, while total factor productivity growth, averaging around 2 per cent a year, has been responsible for less than one-third of economic growth (Table 1.2).

However, the contribution to growth from labour and capital inputs is projected to fall from 4½ per cent in the 1990s to around 2½ per cent during the coming decade (Table 1.2). The growth of labour inputs will be slowed by the gradual implementation of a five-day workweek under legislation passed in September 2003.⁷ Assuming that overtime work stays near its 2002 level, this would cut working time by about 6 per cent by 2009. Declining working hours would largely offset employment growth, which is likely to remain robust, given

Figure 1.7. **Decomposition of the real income gap**

Percentage point differences in GDP per person relative to the OECD average, PPP-adjusted, 2002



1. Total hours worked relative to population.

2. Productivity is measured on a per-hour basis.

Source: OECD.

the continued expansion of the working-age population, and assuming that the upward trend in the labour force participation rate continues and that the unemployment rate remains near its current level. Consequently, the contribution to growth from labour inputs would slow to about $\frac{1}{4}$ percentage point a year, well below the $\frac{1}{4}$ per cent contribution during the past decade. As for capital, the downward trend in the large share of business investment in GDP is unlikely to be reversed as firms become more sensitive to risks. Moreover, the domestic savings pool has been reduced by the significant fall in the household saving rate.

The slower rise in labour and capital inputs means that economic growth will become increasingly dependent on total factor productivity gains. If such gains

were to remain at the level of 2 per cent recorded in the 1990s, potential output growth would fall to 4½ per cent (Table 1.2, Scenario A). Achieving potential growth of 5¼ per cent would thus require that total factor productivity growth accelerate to more than 2½ per cent, an increase that may be harder to achieve as Korea moves closer to average productivity levels in the OECD area. In terms of labour productivity, there would have to be an acceleration from the 4¼ per cent recorded during the 1990s to around 5 per cent (Table 1.4). In summary, as labour and capital inputs are expanding at a slower rate, the challenge is to use these factors more efficiently.

Table 1.4. **Potential output growth over the medium term**

Annual average from 2003 to 2009 in percentage points

	Potential GDP growth rate	Potential labour productivity growth (output per hour)	Potential labour input (total hours worked)	Components of potential employment				Hours worked
				Trend participation rate	Working-age population	Structural unemployment	Potential employment growth	
Korea								
Scenario A¹	4.6	4.3	0.3	0.4	0.9	0.0	1.3	-1.0
Scenario B²	5.2	4.9	0.3	0.4	0.9	0.0	1.3	-1.0
Australia	3.6	2.2	1.4	0.0	1.4	0.0	1.6	0.1
Austria	2.0	1.6	0.4	0.1	0.1	0.0	0.3	0.0
Belgium	2.0	1.5	0.6	0.4	0.3	0.0	0.8	-0.3
Canada	3.0	1.9	1.0	0.1	1.0	0.0	1.1	0.0
Denmark	2.0	1.5	0.5	0.0	0.0	0.0	0.0	0.3
Finland	2.1	2.3	-0.2	-0.4	0.2	0.1	-0.3	-0.3
France	2.1	1.6	0.5	-0.2	0.4	0.1	0.3	0.3
Germany	1.6	1.4	0.2	0.3	-0.2	0.0	0.2	-0.2
Greece	3.6	3.3	0.3	0.2	-0.1	0.1	0.3	0.2
Iceland	2.9	1.9	1.0	0.0	0.9	0.1	0.9	-0.1
Ireland	4.5	3.4	1.0	0.3	1.0	0.1	1.5	-0.2
Italy	1.4	1.0	0.5	0.6	-0.1	0.2	0.4	-0.1
Japan	1.3	1.1	0.2	0.2	-0.4	0.0	-0.2	0.0
Netherlands	1.8	1.1	0.7	0.5	0.4	0.0	0.9	-0.3
New Zealand	3.0	2.1	0.9	0.2	0.9	0.0	1.2	0.0
Norway	2.3	2.0	0.4	0.0	0.5	0.0	0.5	-0.2
Spain	2.6	1.0	1.6	1.4	0.3	0.3	1.5	-0.1
Sweden	2.3	1.5	0.8	-0.2	0.6	0.0	0.5	0.5
Switzerland	1.3	0.6	0.7	0.1	0.5	0.0	0.6	0.0
United Kingdom	2.4	1.9	0.4	0.0	0.4	0.0	0.4	0.0
United States	3.2	1.8	1.4	0.0	1.0	0.0	0.8	0.1
Total OECD ³	2.4	1.7	0.7	0.2	0.4	0.0	0.6	0.0

1. Assumes that labour productivity growth remains close to the level recorded during the past decade with the economic system and the degree of international openness staying unchanged.

2. Assumes that productivity growth will accelerate enough to achieve the government's target of 5 per cent potential growth as a result of structural reform and increasing international openness.

3. Not including Korea.

Source: OECD.

Korea's success in upgrading human capital, promoting R&D and innovation and reducing its barriers to trade suggest that it is well positioned to achieve high total factor productivity growth. The impact of higher levels of education (Figure 1.2) will continue to make an important contribution. For example, the proportion of workers with a university degree is projected to rise further to 32 per cent in 2012 (Table 1.3). Consequently, the human capital index, which is based on the educational attainment of each age cohort by gender, is projected to continue rising at about a 1 per cent rate over the next decade, contributing 0.6 percentage point to the annual growth rate. Moreover, a successful reform of the labour market that allows Korea to more fully benefit from its human capital could lead to a larger contribution from the rising level of educational attainment.

Key challenges facing Korea

A major concern in Korea is that the traditional growth model, driven by high levels of investment in manufacturing industries to boost exports, is no longer capable of sustaining rapid growth. The government has established five strategies to lay the groundwork for achieving the income-doubling objective:

- *Labour-management relations*; establish socially cohesive labour-management relations.
- *Structural reform*; bring the Korean economic system in line with global standards.
- *Technological innovation*: develop science and technology and foster new growth engines.
- *Northeast Asian Economic Hub*; become an international business hub and strengthen economic ties in Northeast Asia.
- *Balanced national development*; promote local areas (*i.e.* outside of the Seoul metropolitan area) to lead innovation and development.

In August 2003, the government announced ten industrial sectors as new growth engines, in which it plans to invest 400 billion won in 2004.⁸ The government is planning the development of technology for each sector and the necessary manpower and infrastructure, and acting as a promoter of these sectors.

A government policy of promoting certain industries to lead the economy, a policy that was tried in the past with mixed results,⁹ contains considerable risks and may introduce important distortions in the economy, which may eventually dampen productivity growth. The evolution of the country's comparative advantage will depend primarily on the efforts and decisions of Korean firms and workers. While market forces, such as changes in demand patterns and advances in technology, should be the main drivers of growth, the government has an important role to play in upgrading the country's capabilities in education, infrastructure

and the innovation framework in order to support an increasingly knowledge-based economy. Growth will be faster in an economy where resources are rapidly reallocated to high-productivity activities in response to market signals. It is thus important to reverse the legacy of government intervention, which is ill-suited to a complex, increasingly globalised economy. To accelerate the speed of adjustment, it is necessary to improve the functioning of the labour market in order to fully benefit from the increasing human capital available in Korea. At the same time, reforms in the corporate and financial sectors are essential to improve the allocation of capital, while limiting government intervention. In addition, strengthening competition is a key to boosting productivity. This section will briefly review the key problems faced in these areas after first discussing the medium-term macroeconomic challenges.

Macroeconomic challenges

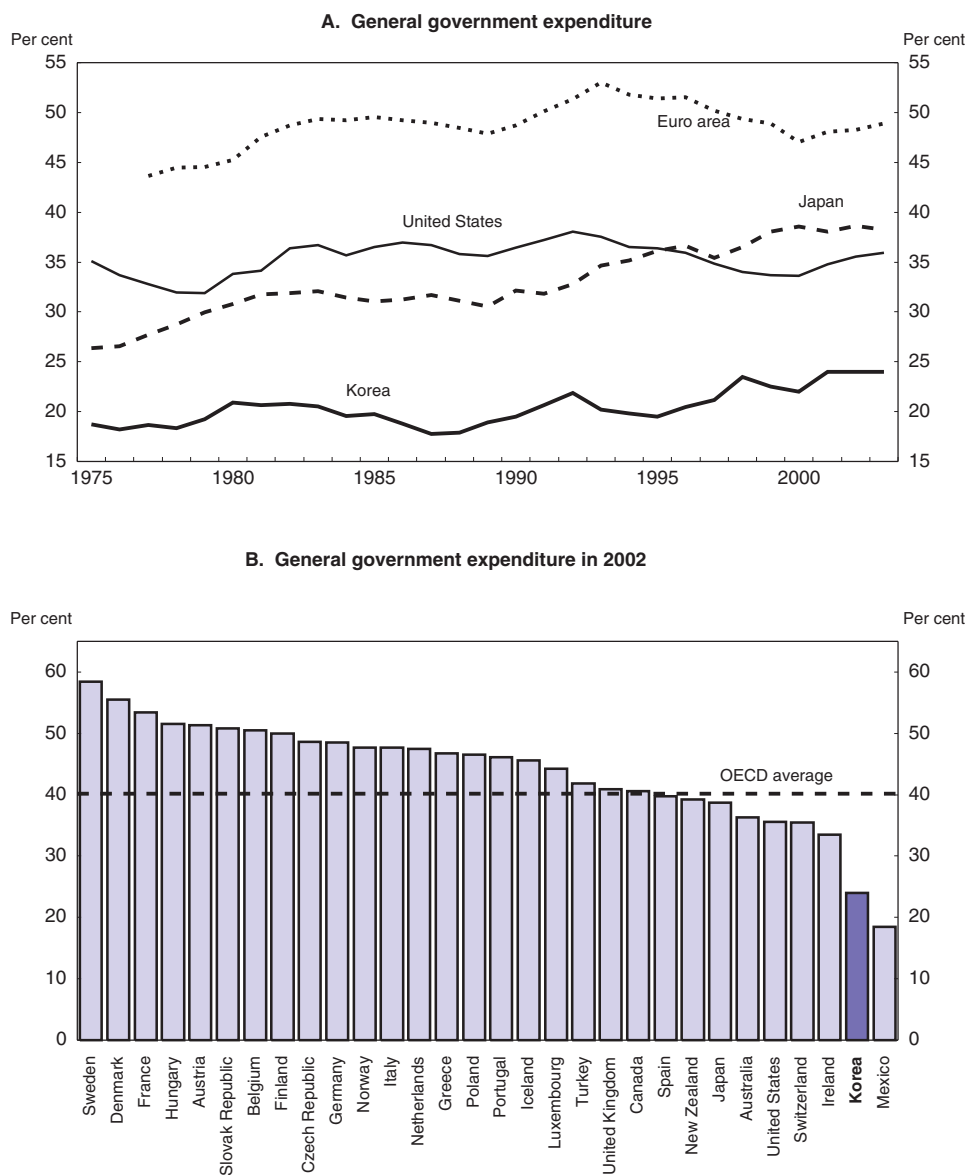
Implementing the new monetary policy framework

Macroeconomic stability depends to some extent on monetary policy, which is conducted under a new framework introduced at the beginning of 2004. As recommended in the 2003 OECD *Economic Survey of Korea*, the independence of the central bank was enhanced and the inflation objective was changed from an annual target to a medium-term objective. The difficulty of achieving the desired targets has been heightened by the extensive restructuring of the financial sector since the crisis, which has increased uncertainty about the link between policy interest rates and market interest rates, as well as the impact of interest rate changes on economic activity. Moreover, the exchange rate and the persistent increases in real estate prices also influence the setting of monetary policy.

Spending pressures arising from population ageing and economic co-operation with the North

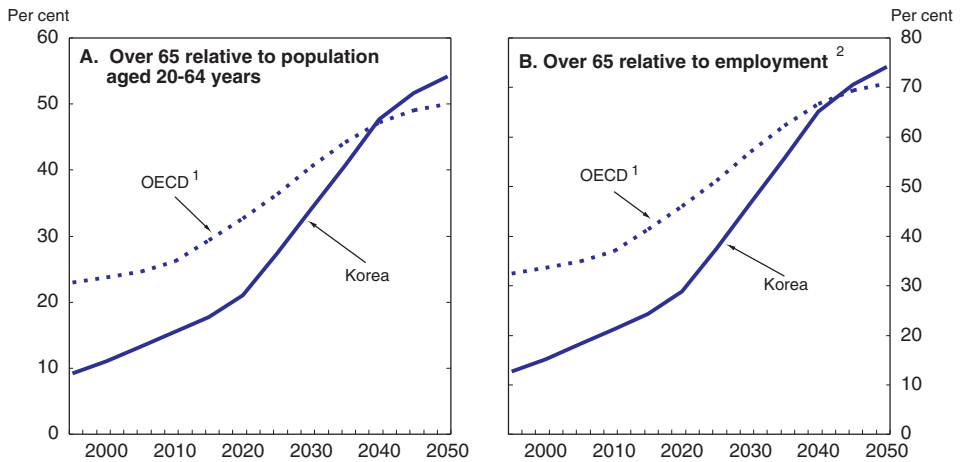
Korea has an exceptionally sound fiscal position. Gross public debt – at around 35 per cent of GDP, including guaranteed debt – is well below the OECD average and Korea is one of only three member countries in which the government is a net creditor. Government spending is the second lowest in the OECD area, at 24 per cent of GDP (Figure 1.8), reflecting the immaturity of the social welfare system and the relatively low level of public services. However, rapid population ageing will create considerable pressure for increased public expenditures. The old-age dependency ratio, the second lowest among member countries at present, is projected to surpass the OECD average before the middle of the century, reflecting the sharp fall in fertility and rising life expectancy (Figure 1.9). At the same time, increased urbanisation and the changing role of women have weakened the traditional support system for the elderly that was based on the extended family. The National Pension Scheme, created in 1988, promises to provide a pension set at 60 per cent of average earnings. However, it requires a major

Figure 1.8. **Public spending in international comparison¹**
Per cent of GDP



1. Public spending is defined as the sum of current outlays and net capital outlays. Data are based on SNA93/ESA95.
Source: OECD.

Figure 1.9. Old-age dependency ratios



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.

overhaul to ensure its sustainability. Population ageing and the development of the social safety net is likely to boost publicly funded social expenditures, which were 6 per cent of GDP in 2001 compared to an OECD average of 21 per cent. Spending pressures will necessitate increased government revenue, which will result in significant deadweight losses resulting from such problems as overly generous allowances for individuals, large-scale and wide-ranging tax preferences for enterprises, an inappropriate taxation of property and a lack of strong and uniform tax enforcement.

The cost of economic integration with North Korea poses another potentially large fiscal burden. In the Berlin Declaration of 2000, the South promised to provide economic assistance to the North. While aid from the South and other countries may have helped stabilise conditions in North Korea, economic output remains well below the level of the early 1990s. Given the chronic food shortages and the deterioration in economic conditions in the North during the past decade, the cost of economic integration may be enormous. Compared to Germany, the burden of integration is likely to be heavier, given that the population of North Korea is one-half that of the South, while the per capita income gap may be more than 13 to one.¹⁰ The challenges of rapid population ageing and North Korea underline the importance of establishing more effective budgeting frameworks and increasing efficiency in meeting the objectives of government spending programmes.

In sum, the key macroeconomic challenges, which are addressed in Chapter 2, are:

- Ensuring that monetary policy effectively promotes stability under the new framework in the context of pressure on the exchange rate and real estate prices.
- Coping with the fiscal pressures stemming from rapid population ageing, the development of the social safety net and economic co-operation with North Korea.
- Increasing the efficiency of the tax system, thereby reducing deadweight costs, as government revenue increases to match the rise in spending.
- Enhancing the efficiency and transparency of the public expenditure management system, while improving public service delivery and accountability for results.

The labour market: dualism and a lack of flexibility

Concerns about a “jobless recovery” have arisen as employment declined in 2003 despite the economic rebound in the second half of the year. This resulted in an unemployment rate of 7.7 per cent for young adults in the 15 to 29 age group in 2003, compared to an overall rate of 3.4 per cent. With the working-age population increasing about 1 per cent a year, achieving adequate job creation is a major challenge, heightened by the declining number of manufacturing jobs and the outflow of investment, particularly to China.

Korea’s contentious labour-management relations did not improve significantly last year. In the Ministry of Labour’s view, “Escalated industrial conflicts between monopolistic management and powerful trade unions are dragging down the nation’s economy”.¹¹ The uncooperative relationship between workers and management poses a stumbling block to labour market flexibility. Although the labour code was revised in 1998 to allow layoffs for managerial reasons, they are subject to a number of conditions, making it doubtful whether the reform enhanced flexibility in practice. Employment flexibility is also hindered by the strong opposition of workers to dismissals, which reflects to some extent the limited development of the social safety net, despite some progress. Indeed, less than one-fifth of the unemployed in 2003 received unemployment benefits. In addition, active labour market policies play a relatively minor role, accounting for less than 0.5 per cent of GDP, reflecting limited outlays on training for unemployed persons. Problematic industrial relations in some companies undermine business confidence and investment, as well as discouraging inflows of foreign direct investment, which have fallen by about half from the 1999-2000 level.

The higher level of employment protection granted to regular workers has encouraged firms to hire non-regular workers. Moreover, their wages are 20 to

27 per cent less on average than regular workers, after adjusting for employees' characteristics (Jeong, 2003), and they are excluded from some aspects of the social safety net. Non-regular workers are estimated to account for a quarter of total employees in 2003.¹² The emergence of a dualistic labour market in which one segment is subject to lower wages, less protection from the social safety net and greater job precariousness, creates equity concerns. Another labour market issue is the practice of seniority-based wages, which makes older workers relatively expensive. Consequently, firms tend to let workers go at around the age of 55, forcing them to seek self-employment or to exit from the labour force. Such a system is ill-suited for a rapidly ageing labour force as it tends to reduce participation in the labour force. The participation rate is also held down by the relatively low rate for women.

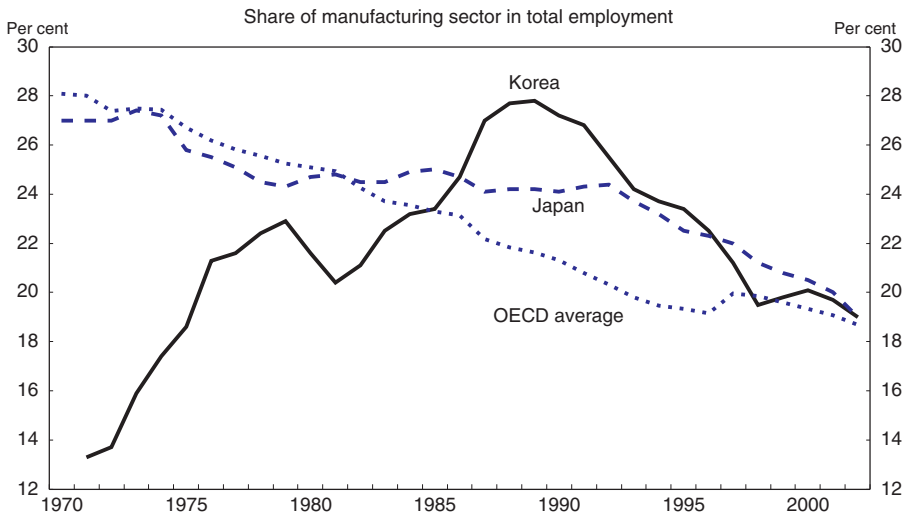
In sum, the key labour market challenges, which are addressed in Chapter 3, are:

- Reversing the decline in employment in 2003.
- Reducing the dualism in the labour market resulting from the increased use of non-regular workers.
- Increasing labour market flexibility.
- Expanding the effective coverage of the social safety net.
- Ensuring that active labour market policies are effective.
- Establishing more co-operative and harmonious industrial relations.
- Raising the labour force participation rate over the medium term in order to cope with population ageing.

Restructuring the corporate and financial sectors

Korea's corporate sector is still in the process of restructuring in the wake of the 1997 financial crisis, which led to significant changes, such as stronger competitive pressures, more independent financial institutions and a new corporate governance framework. The decline in the manufacturing sector's share of employment, which peaked at 28 per cent in the late 1980s, has resumed after being briefly reversed following the crisis in response to the one-third decline in the effective exchange rate between 1996 and 1998 (Figure 1.10). Indeed, there appears to be an accelerated shift of manufacturing abroad. A 2002 survey by the Korea Chamber of Commerce and Industry reported that 44 per cent of major companies had already moved some production sites outside of Korea and 34 per cent were planning such transfers. The major objective cited was to lower production costs. According to the Ministry of Commerce, Industry and Energy, labour-intensive manufacturing, which accounts for about a quarter of manufactured output, accounted for 46 per cent of that sector's overseas investment in 2003.

Figure 1.10. De-industrialisation in the OECD area

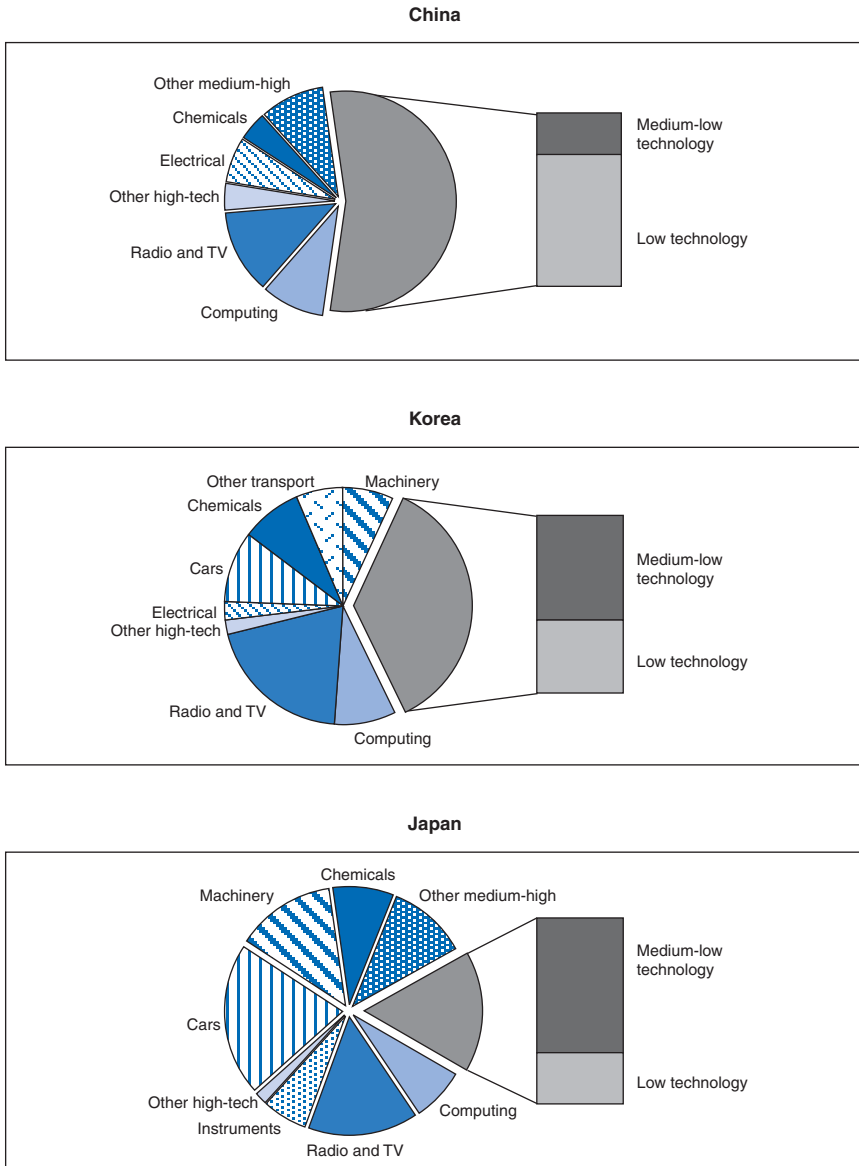


Source: Rowthorn and Coutts (2004).

Much of the concern about de-industrialisation is connected to competition from China. For example, in the survey cited above, four-fifths of the companies planning to move production abroad had chosen China as the destination. Korea is sandwiched both geographically and economically between a rapidly growing China, which is quickly moving up the product ladder, and Japan, which retains a comparative advantage in a number of advanced industries. The composition of exports illustrates Korea's position between its larger neighbours (Figure 1.11). In China, where wages are less than one-fifth of Korean levels, low and medium-low technology products, notably textiles, account for more than half of exports. However, Chinese exports of high and medium-high technology products, such as office, accounting and computing machinery, electrical products, radio, television and communication goods, are increasing rapidly. On the other hand, the strength of Japanese exports lies in more advanced products, while low and medium-low technology products account for only a quarter. Korea lies in between its two neighbours in terms of the proportion of high-tech goods in its exports. The evolution of Korea's comparative advantage will depend on the effectiveness of its large investment in knowledge.

However, the concern about de-industrialisation and the shift of jobs overseas appears to be exaggerated. The shift to fewer, but higher-paying, jobs in manufacturing is part of the process that allows income to increase at such a rapid

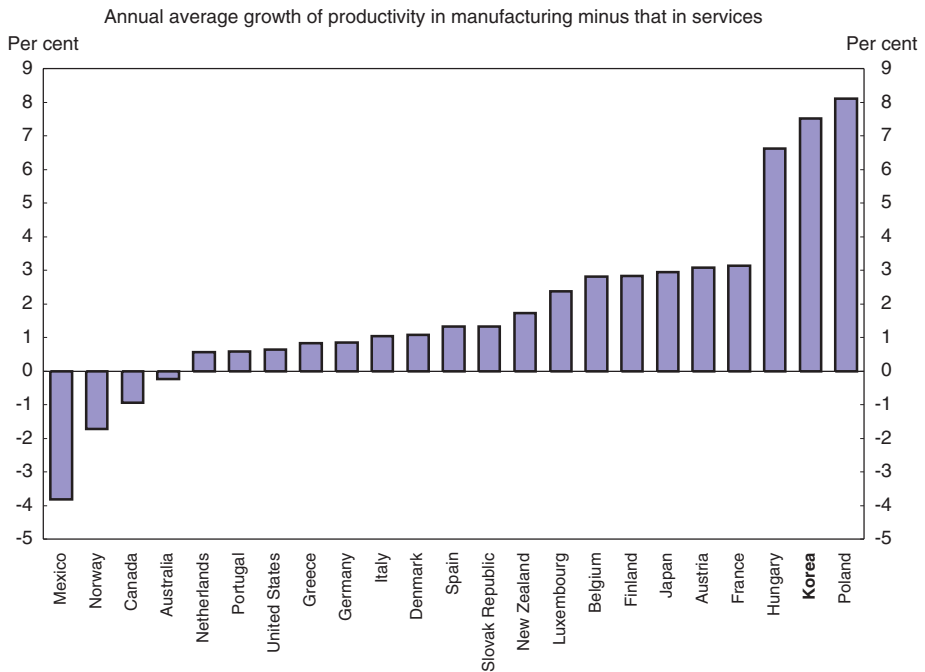
Figure 1.11. **The composition of exports of China, Korea and Japan**
By main sector and degree of technology intensity, 2001



Source: OECD, Bilateral Trade Database, 2003.

rate in Korea. Part of this process in OECD countries has been a growing role for the service sector, an area where productivity in Korea is relatively low. The share of knowledge-intensive services – post and telecommunications, finance and insurance and business services – in GDP is the third lowest in the OECD area (Figure 1.5). As for business-sector R&D, only 12 per cent takes place in the service sector, about half of the OECD average. Moreover, in Korea, service sector productivity is around 60 per cent of that in manufacturing, the largest gap in the OECD area. The gap did not narrow during the latter part of the 1990s, as annual productivity growth was more than 7 percentage points higher in manufacturing than in the service sector (Figure 1.12).

Figure 1.12. **Productivity in the service sector¹**
1995-2000



1. Productivity is defined as output per worker. The service sector includes wholesale and retail trade, hotels and restaurants, transport, storage and communication, financial intermediation, real estate and other business activities. Electricity, gas and water have been included in the manufacturing sector.

Source: OECD.

The corporate sector has evolved significantly since the crisis. In particular, the high leverage that was typical prior to the crisis has been sharply reduced. For the manufacturing sector, the debt to equity ratio fell from nearly 400 per cent in 1997 to 123 per cent in 2003. Increased competition, more independent financial institutions subject to improved supervision, a new corporate governance framework and measures to improve the auditing framework have been catalysts in changing behaviour in the corporate sector. However, the accounting scandal at SK Global demonstrated that there are remaining weaknesses in the auditing framework, leading to a lack of transparency. In corporate governance, current practices lag significantly behind the institutional changes. For example, while independent directors have been granted a larger role, their influence on corporate management appears to have been limited.

The restructuring of the corporate sector has had major repercussions on the financial sector. While considerable progress has been achieved in the banking sector, which has regained profitability, cut non-performing loans to record low levels and boosted capital adequacy ratios, the restructuring of the non-bank sector is less advanced. Despite the injection of nearly \$7 billion in public funds for restructuring, the investment trust companies (ITCs) have not recovered from past shocks, such as the collapse of Daewoo in 1999, thus leading to problems in the corporate bond market. The ITCs were also negatively affected by the failure of SK Global in 2003 and the problems in the credit card companies. The sharp rise in the delinquency ratio and in the amount of rescheduled loans resulted in serious liquidity and solvency problems in the credit card companies, with adverse effects on private consumption. The government co-ordinated a rescue for the largest company, LG Card, by 14 financial institutions, including a state-owned bank, on the grounds that its failure could pose systemic risks, although this may increase moral hazard problems. More generally, the credit card bubble suggests that risk-management practices in the financial sector are still underdeveloped.

In sum, the key challenges in the financial and corporate sectors, which are addressed in Chapter 4, are:

- Upgrading the innovation framework in order to get the most benefit possible out of Korea's large investment in knowledge.
- Improving the corporate governance and auditing frameworks and practices in order to achieve a better allocation of capital, enhance transparency and reduce the scope for managerial abuse.
- Resolving the problems in the non-bank financial sector, notably in the credit card companies and the investment trust companies.
- Improving supervision to avoid future liquidity and solvency problems in the financial sector.

Enhancing competition to boost growth

The Anti-Monopoly and Fair Trade Act is enforced by the Korea Fair Trade Commission (KFTC), an independent and powerful agency. However, there are weaknesses in competition policy. In particular, the KFTC's power to obtain evidence is not backed up by effective judicial sanctions, while private actions and criminal enforcement are rare. Moreover, the law includes major exemptions and special treatment for some sectors, such as small and medium-sized enterprises. In some areas, the commitment to competition principles has been tempered by various forms of government intervention aimed at accelerating growth.

In addition, the emphasis on "fair trade" has led the competition authority to focus on financial oversight of the chaebol, which may limit its capacity to enforce more conventional aspects of competition law. The chaebol, which played a key role in both the rapid industrialisation of Korea and in the 1997 crisis, remain a difficult dilemma for policymakers. Chaebol are multi-company business groups operating in a wide range of markets under common entrepreneurial and financial control. A number of regulations have been introduced since 1987 to limit their growth,¹³ although their effectiveness is questionable. However, the transformation of the economic environment following the crisis has led to significant changes in the corporate sector. Of the top 30 chaebol in 1997, seventeen have entered legal bankruptcy procedures or been forced into workout programmes, including Daewoo, which was the second largest group. Meanwhile, a number of others lost control of large affiliated firms. In addition, the average debt-to-equity ratio fell to 116 per cent from more than 500 per cent at the time of the crisis. Nevertheless, there remains concern about possible negative effects stemming from the concentration of power in the business groups, adverse impacts on competition in product markets and the possibilities of managerial abuse. The founding families have been able to exercise *de facto* control over legally-independent firms, although their ownership shares have fallen to an average of 4 per cent. This has created opportunities for the owner families to expropriate outside shareholders through transfers between affiliated firms.

Policymakers face the difficult questions of how serious these problems are in reality and what policies are necessary to address them. Moreover, policies to deal with chaebol issues are constrained by a number of considerations. *First*, the development of the business groups was linked to past authoritarian governments, raising questions about their legitimacy and making them politically unpopular. *Second*, the chaebol, which include key exporters such as Samsung and Hyundai, have a major impact on economic growth. Efforts to reform or change the behaviour of the business groups can therefore have a significant influence on growth and employment prospects in the short run. *Third*, the increasing integration of Korea in the world economy has weakened the rationale for the restrictions on the business groups. For example, allowing the chaebol's foreign competitors

to purchase Korean firms while the chaebol themselves remain subject to investment ceilings raises questions of fairness.

As noted above, the gap between labour productivity in the manufacturing and service sectors is exceptionally large in Korea. Consequently, continuing the process of convergence to the income levels in the advanced countries will depend to a considerable extent on raising productivity in the service sector, whose share of the economy is likely to continue expanding. Such gains depend in part on strengthening competition, particularly in the network industries. In the retail sector, the application process for opening large-scale retail stores limits competition. The important role of professional associations may also have harmful effects, such as creating entry barriers or price-fixing agreements. In the telecommunication sector, the market power of the dominant firms in both the fixed line and mobile telephony markets raises difficult challenges for competition. The government's ten-year plan to introduce competition in the electricity sector has fallen behind schedule, in part due to opposition from labour, while the initial efforts to privatise the generating companies have been unsuccessful. In both electricity and telecommunications, a key missing element is an independent and pro-active regulatory body, which has been found to be necessary for competition in other OECD countries.

International competition is hindered by an average tariff level that is more than double that in the major OECD countries. In particular, the level of protection provided for the agricultural sector is exceptionally high. Strong opposition from farmers delayed the approval of Korea's first free trade agreement, with Chile, and limits the scope for Korea's participation in regional trade agreements that would allow it to benefit more fully from Asia's economic dynamism. As noted above, FDI inflows have declined during the past three years, in part due to labour market problems, following a surge in the late 1990s.

In sum, the key challenges to strengthening competition, which are addressed in Chapter 5, are:

- Upgrading the enforcement and coverage of competition policy.
- Reducing entry barriers in the service sector.
- Ensuring the necessary conditions for competition in the network industries.
- Dealing effectively with the chaebol.
- Opening further to imports and inflows of foreign direct investment.

Conclusion

Korea's accelerated economic development has transformed it from one of the poorest countries in the world 40 years ago to a leading industrial nation. The economic growth rate during the past decade, at an annual pace of 5.6 per

cent, has been one of the fastest in the OECD area. However, the contribution to growth from factor inputs is expected to slow over the medium term. Consequently, maintaining growth at an annual average rate of 5 per cent or higher would require that labour productivity growth accelerate from its 4¼ per cent pace during the past decade to at least 4¾ per cent, implying an acceleration of total factor productivity growth.

A number of factors, such as investment in physical capital, education and R&D, explain the country's success in moving into technologically-advanced sectors and suggest that it has the potential to maintain growth at high rates that would rapidly achieve the government's income-doubling objective. Moreover, the large gap between productivity levels in Korea and the OECD average indicates that there is considerable scope to continue the convergence process towards the income levels in the most advanced nations. However, effectively exploiting Korea's growth potential will depend on reforms in a number of areas. Although the wide-ranging programme implemented in the wake of the 1997 crisis made major improvements in key areas, the reform agenda remains unfinished. One challenge, discussed in Chapter 2, will be to maintain macroeconomic stability and ensure fiscal sustainability in the context of rapid population ageing and other spending pressures. Chapter 3 discusses measures to improve the functioning of the labour market, while Chapter 4 examines policies related to the corporate and financial sector. The final chapter examines the challenge of strengthening competition in the Korean economy. Action in all of the areas would allow Korea to continue its progress in becoming a high-income OECD country.

Notes

1. Ministry of Finance and Economy (2003), *Economic Policy Directions*. In 2002, per capita gross national income was around \$10 000. The revision of national accounts in March 2004 boosted that figure by 15 per cent to about \$11 500.
2. This study divided potential output gains into factor inputs and total factor productivity growth. This approach requires measuring the quality of inputs of labour and capital, although the latter is difficult to quantify. The output gain not explained by the quality-adjusted inputs is often used as an indicator of technological progress (see *The Sources of Economic Growth in OECD Countries* [OECD, 2003e]). In the growth de-composition shown in Table 1.1, growth is divided into labour inputs and labour productivity. The latter term shows the impact of changes in the quality of labour, changes in the quantity and quality of capital inputs and technological progress, as well as other factors.
3. The “technology balance of payments” is defined as the balance of international payments resulting from the transfer of techniques (through patents and licenses), the transfer of designs, trademarks and patterns, services with a technical content (such as engineering studies) and industrial R&D (OECD *Science, Technology and Industry Scoreboard*, 2003, Table C.5.4).
4. This does not include outlays on private educational institutes, known as *hakwon*, which account for 5 per cent of total household spending.
5. Business R&D in this sector amounts to nearly 1 per cent of GDP, a level second only to Finland.
6. As in other OECD countries, the rate would be higher if discouraged workers were included. Such workers may be relatively high in Korea, as reflected in fluctuations in the labour force participation rate. This may be one reason for the relatively low participation rate as noted below.
7. The amended Labour Standards Act reduces the maximum standard workweek from 44 to 40 hours. Implementation will begin at workplaces with more than 1 000 employees in July 2004 and will be extended gradually to those with more than 20 employees in 2008. For workplaces below this threshold, the five-day workweek will be introduced sometime before 2011.
8. The ten industries are: intelligent robots; future automobiles; next-generation semiconductors; digital television and broadcasting; next-generation mobile communications; next-generation computer displays; intelligent home networks; digital content and software solutions; next-generation batteries; and biomedical products and artificial organs.
9. In particular, the Heavy and Chemical Industry (HCI) drive of the 1970s targeted certain industries and provided a number of special incentives, notably the allocation of credit to favoured industries and selective trade and tax policies. This policy ended when

Korea faced serious economic problems in 1980 stemming from over-investment and low profitability in some of the sectors targeted by the HCI drive, which were compounded by the second oil shock and political instability.

10. In comparison, East Germany's population was less than a third of West Germany's at the time of German re-unification, while the income gap was smaller, with per capita income in East Germany around half of that in the West. Moreover, South Korea would face this challenge at a lower level of income than in the case of West Germany.
11. Ministry of Labour (2003), *Reform Proposal for Sound Industrial Relations*, Seoul.
12. Regular workers are defined as those that work more than one year at a firm and are paid standard wages, plus bonuses and overtime. Officially, the proportion of non-regular workers rose from 46 per cent of wage and salary employees in 1997 to 49 per cent in 2003. However, a significant proportion of employees classified as non-regular remain with their employer on a longer-term basis. Nonetheless, even the revised estimate of 24 per cent (see Chapter 3) is high by OECD standards and, in any case, has been increasing in recent years.
13. In particular, the Monopoly Regulation and Fair Trade Act prohibits cross-shareholding between affiliates of chaebol, limits loan guarantees and monitors commercial exchanges between them. In addition, shareholding in other domestic companies by chaebol-affiliated firms is restricted in order to limit the expansion and diversification of the business groups.

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BASIC STATISTICS OF KOREA

THE LAND

Area (thousand sq. km)	100	Major cities, 2001 (million inhabitants):	
Agricultural area (thousand sq. km)	14	Seoul	10.3
Forests (thousand sq. km)	65	Pusan	3.8
		Taegu	2.6
		Incheon	2.5

THE PEOPLE

Population, 2003 (million)	47.9	Civilian labour force, 2003 (million)	22.9
Per sq. km, 2003	479	Civilian employment	22.1
Annual rate of change of population, 2003	0.5	Agriculture, forestry, fishing	1.9
		Industry	4.2
		Construction	1.8
		Services	14.2

PRODUCTION

GDP, 2003 (trillion won)	720.9	Origin of GDP, 2003 (per cent of total):	
GDP per head (US\$)	12 630	Agriculture, forestry, fishing	3.9
Gross fixed investment, 2003 (trillion won)	183.2	Industry	32.7
Per cent of GDP	29.6	Construction	8.6
Per head (US\$)	3 735	Services	54.8

THE GOVERNMENT

Public consumption, 2003 (per cent of GDP)	13.3	Composition of the National Assembly:	
Central government revenue, 2003, consolidated basis (per cent of GDP)	23.9	June 2004	<u>152</u>
Central government budget balance, 2003, consolidated basis (per cent of GDP)	1.1	The Uri Party	121
		The Grand National Party	<u>26</u>
		Other	299

FOREIGN TRADE

Commodity exports, 2003, f.o.b. (per cent of GDP)	32.0	Commodity imports, 2003, c.i.f. (per cent of GDP)	29.5
Main exports (per cent of total exports):		Main imports (per cent of total imports):	
Light industry products	14.1	Consumer goods	13.2
Heavy industry products	79.8	Industrial materials and fuels	48.3
Electronic products	30.6	Crude petroleum	12.8
Cars	9.0	Capital goods	38.5

THE CURRENCY

Monetary unit: won		Currency unit per US\$, average of daily figures:	
		2002	1 251
		2003	1 191
		May 2004	1 169

Note: An international comparison of certain basic statistics is given in an annex table.

This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

•

The economic situation and policies of Korea were reviewed by the Committee on 3 May 2004. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 1 June 2004.

•

The Secretariat's draft report was prepared for the Committee by Randall Jones, Yongchun Baek and Michael Wise under the supervision of Willi Leibfritz.

•

The previous Survey of Korea was issued in March 2003.

Executive summary

Korea has been one of the fastest-growing economies in the OECD area over the past five years, with an annual growth rate of about 6 per cent. Such rapid growth, which has lifted per capita income to two-thirds of the OECD average, reflects Korea's underlying dynamism and its progress in implementing a wide-ranging reform programme in the wake of the 1997 crisis. However, the recession in 2003 – which was due in part to structural problems in the labour market and in the corporate and financial sectors – indicates that the reform agenda is unfinished. Sustaining rapid growth over the medium term as the contribution from inputs of labour and capital slows requires further progress in structural reform, particularly in the labour market and in the corporate and financial sectors, accompanied by appropriate macroeconomic policies.

Macroeconomic policies to promote stability and deal with rising spending pressures

Monetary policy should focus on the newly established medium-term inflation target. Putting a stop to foreign reserve accumulation would limit the need for higher interest rates over the business cycle and tend to promote a more balanced expansion over the medium term. Given the pressure for increased public expenditure due to population ageing and the development of the social safety net, as well as the potential costs of economic co-operation with North Korea, fiscal policy should aim at a balanced budget, excluding the social security surplus, over the business cycle. Anchoring spending decisions in a medium-term framework and increasing the efficiency of the public expenditure system would also help contain spending pressures. In addition, fundamental reform of the pension system is essential to ensure its sustainability in the context of exceptionally rapid population ageing. Reform should aim at expanding the effective coverage of the public pension system and developing private-sector saving for retirement.

The key long-term challenge is to raise productivity growth by:

Improving the functioning of the labour market

A comprehensive reform package is needed to increase employment flexibility, create more co-operative industrial relations and reduce the extent of dual-

ism in the labour market, which creates equity concerns. Relaxing employment protection for regular workers and improving the coverage of the social safety net, especially for non-regular workers who account for about a quarter of all employees, would enhance flexibility and reduce labour market dualism. The government should promote an industrial relations framework in which workers and management settle their disputes autonomously. Active labour market policies should be improved while limiting deadweight costs. Over the longer term, boosting labour force participation rates, focusing on older workers and women, is essential to cope with rapid population ageing.

Reforms in the corporate and financial sectors

Further progress in implementing the new corporate governance framework, combined with improved financial supervision and strengthened competitive pressures, are important to effectively discipline chaebol behaviour and guide corporate restructuring. The 2003 accounting scandal demonstrates the need to improve auditing procedures to enhance transparency. In the financial sector, the privatisation of the commercial banks should continue. It is also necessary to promptly resolve the problems in the non-bank sector, notably in the credit card companies, which have impinged on private consumption, and in the investment trust companies. Shifting financial supervision to a more pre-emptive and risk-based approach would help avoid future problems in the financial sector.

Strengthening competition to enhance productivity growth

Competition policy should be strengthened by granting the Korea Fair Trade Commission compulsory investigative powers, making the threat of individual sanctions more credible and removing exemptions from the competition law. The benefits of increased competition are likely to be strongest in the service sector, where productivity levels are significantly lower than in the manufacturing sector. Competition should be strengthened by removing barriers to large retail outlets and eliminating unnecessary constraints on professional services. Simplifying land-use regulations, which are governed by 112 laws, may also reduce entry barriers. It is also important to accelerate efforts to expand the scope of competition in network industries through privatisation and the unbundling of their activities. Another key to competition is the establishment of sectoral regulators that are independent of the ministries responsible for promoting the development of network industries. Foreign competition should be increased by further reducing barriers to imports while addressing features, such as labour market problems, that tend to discourage inflows of direct investment.



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