2. Economic prospects and macroeconomic policies

Korea is rebounding gradually from the downturn in the first half of 2003. Output growth at an 11 per cent seasonally-adjusted annual rate in the fourth quarter of 2003 suggests a strong recovery. However, the large gap between buoyant exports and still sluggish domestic demand, with private consumption still declining, indicates that a full-fledged recovery is not yet underway. On the other hand, there is not much slack in the labour market, where unemployment is at a low level and wage growth has been high. These conflicting signals make it exceptionally difficult to project the path of the recovery and the appropriate macroeconomic policies. This chapter begins by providing short-term projections before turning to the macroeconomic policy issues. The second section considers monetary policy and the related issues of exchange rate policy and the real estate market. Fiscal policy issues, including the pension system, are discussed in the third section, while the fourth section considers how to improve the efficiency of public expenditure, by providing a follow-up to the special chapter in the 2003 OECD *Economic Survey of Korea*. The chapter concludes with an assessment.

Economic prospects

Korea is gradually emerging from an economic downturn caused by sluggish domestic demand, despite buoyant export growth. Exports increased 16 per cent in volume terms in 2003 (Table 2.1), thanks in large part to China, which has become Korea's largest trading partner. Korean exports to China are increasing at nearly a 50 per cent year-on-year rate in dollar terms. The decline in the effective exchange rate during the course of 2003 also had a positive effect. However, robust export growth could not prevent a decline in both private consumption and investment in machinery and equipment in 2003. The dualistic nature of growth is reflected in the gap between the 5 per cent rise in manufacturing output and the 2 per cent increase in the service sector, an outcome that had negative implications for employment, which declined for the first time since 1998. With a recession in the first half of 2003, output growth for the year as a whole slowed to 3.1 per cent, the slowest since the crisis.

Table 2.1. **Economic outlook**[1]
Percentage change in constant 1995 prices

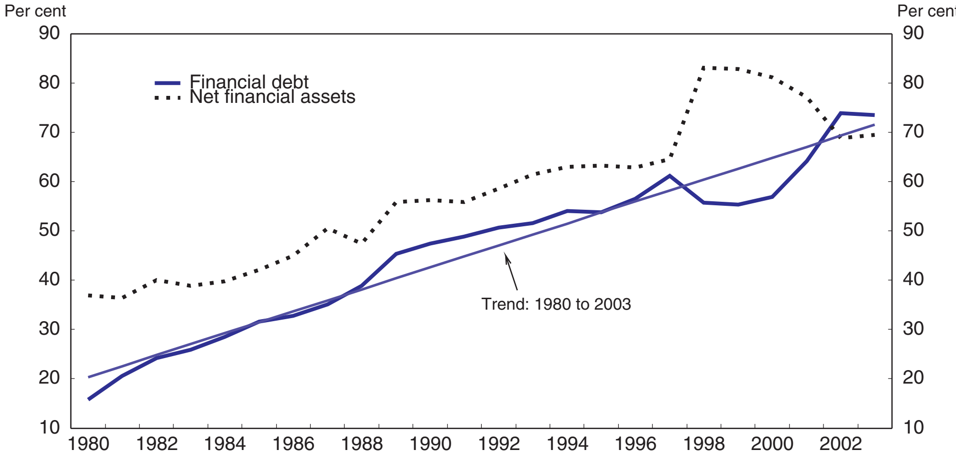
	Share of GDP in 2000[3]	2000	2001	2002	2003	2004	2005
Demand and output							
Private consumption	53.9	8.4	4.9	7.9	–1.4	2.5	5.0
Government consumption	12.1	1.6	4.9	6.0	3.7	3.0	3.0
Gross fixed capital formation	31.1	12.2	–0.2	6.6	3.6	4.7	5.7
Final domestic demand	97.1	8.7	3.1	7.3	0.8	3.2	5.0
Stockbuilding[2]	0.0	–0.2	0.1	–0.2	–0.7	0.0	0.0
Total domestic demand	97.0	8.5	3.2	7.1	0.0	3.3	5.0
Exports of goods and services	40.9	19.1	–2.7	13.3	15.7	18.0	14.0
Imports of goods and services	37.7	20.1	–4.2	15.2	9.7	14.0	13.5
Foreign balance[2]	3.2	0.2	0.5	–0.3	2.8	2.6	1.3
GDP	100.0	8.5	3.8	7.0	3.1	5.6	5.9
Prices							
GDP deflator		0.7	3.5	2.9	2.3	2.0	2.3
Private consumption deflator		4.7	4.8	2.8	3.4	3.2	3.2
Consumer price index		2.3	4.1	2.7	3.6	3.2	3.2
Labour market							
Employment growth		4.3	2.0	2.8	–0.1	1.7	1.2
Participation rate[4]		61.0	61.3	61.9	61.4	61.7	61.7
Average wage		8.0	5.1	11.2	9.2	6.0	7.0
Unemployment rate		4.1	3.8	3.1	3.4	3.3	3.0
Balance of payments							
Current account (US$ billions)		12.2	8.0	5.4	12.3	14.7	16.5
As a percentage of GDP		2.4	1.7	1.0	2.0	2.2	2.3

1. These projections are identical to those published in the OECD *Economic Outlook* No. 75 (June 2004).
2. Contribution to GDP growth.
3. The components shown below do not sum to 100 per cent due to a statistical discrepancy equivalent to –0.2 per cent of GDP.
4. Labour force as a share of population age 15 and over.

Source: OECD.

The failure of strong export growth to translate into a sustained recovery in domestic demand thus far is partly due to external shocks, such as the North Korean nuclear issue, that have undermined confidence. However, the main reason was the end of the private consumption boom due to several factors. *First*, the sharp run-up in household debt, from 56 per cent of GDP in 1998 to 74 per cent in 2002, was followed by a period of retrenchment for households (Figure 2.1). *Second*, the problems in the credit card companies, in the wake of the three-fold rise in the delinquency rate to 14 per cent by the end of 2003, caused them to reduce lending to the household sector (see Chapter 4). Domestic demand was also negatively affected by domestic shocks, notably labour unrest and the SK Global accounting scandal in 2003, which exacerbated the fall in both household and business confidence.

Figure 2.1. **Household financial assets and liabilities**
Per cent of GDP[1]



1. For the "Individual Sector" in the Bank of Korea's flow of funds data.
Source: Bank of Korea.

The further acceleration of export growth – to 38 per cent year-on-year in US dollar terms in the first quarter of 2004 – is expected to spark stronger growth in domestic demand during the course of 2004. Investment in machinery and equipment already turned positive in the final quarter of 2003 and should gain momentum during 2004. However, the rebound in consumption may be modest for a number of reasons. *First*, despite the decline in private consumption in 2003, the level of household debt is still somewhat above its long-term trend (Figure 2.1). *Second*, the on-going problems in the credit card sector may lead to a further reduction in lending to households. *Third*, consumer confidence has weakened in the most recent months. *Fourth*, in the Social Pact for Job Creation in February 2004, the major union confederation agreed that high-paid workers will accept wage stability over the next two years (see Chapter 3).

In summary, continued strong export growth in the context of rising world trade and a moderate pick-up in domestic demand is expected to lift output growth to the 5 to 6 per cent range in 2004 and 2005. The export-led nature of the recovery may keep the current account surplus at around 2 per cent of GDP in 2004 and 2005. The recovery is likely to quickly absorb the remaining slack in the labour market, where the unemployment rate is already low at 3.4 per cent (seasonally-adjusted) in the first quarter of 2004. The relatively low level of unemployment may also help explain the still-high increase in wages – 9 per cent in 2003 compared to 11 per cent in 2002 – although this also reflects the importance of bonus payments, which are linked to the previous year's profits, in employee compensation.[1] This contributed to unit labour cost increases of 6.8 and 5.8 per cent in 2002 and 2003, respectively. Thus far, the core measure of consumer price inflation, which excludes petroleum-based fuels and non-grain farm products, has remained at around 2¾ per cent, near the mid-point of the Bank of Korea's medium-term inflation target.

There are risks, though, attached to the projection of an expansion through 2004 and 2005. In particular, there is uncertainty about private consumption, given the still weak level of household confidence. With their debt still at a high level, there is a risk that households will raise their saving rate in order to improve their financial position. A second risk is a slowdown in export demand, particularly in China, which has been the major factor driving the growth of exports.

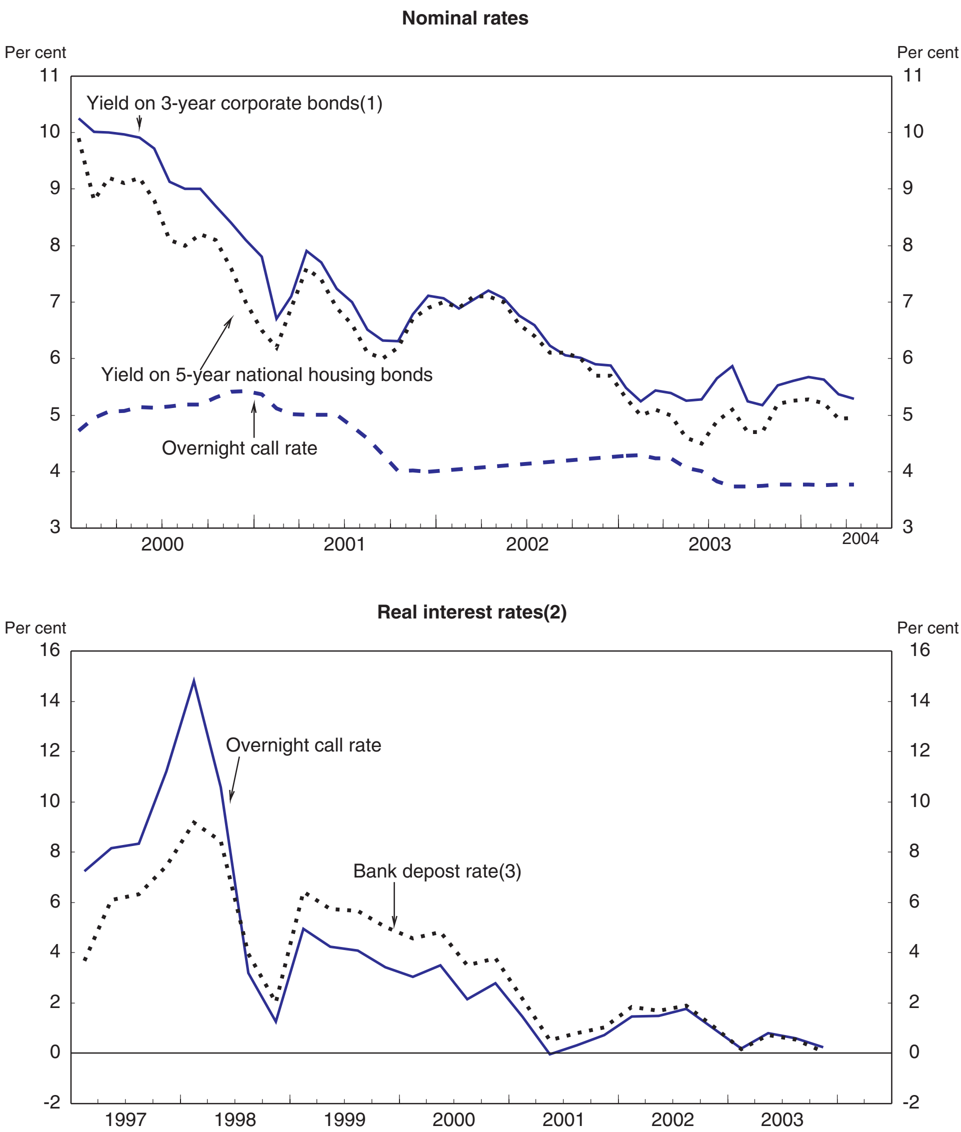
Monetary and exchange rate policy

Monetary policy under the new framework

The revision of the Bank of Korea Act that took effect in 2004 has significantly changed the framework for monetary policy, as recommended in previous OECD *Economic Surveys of Korea*. *First*, the inflation objective has been changed from an annual to a medium-term target, which is the norm in OECD countries that target inflation. The medium term is defined as three years. This reform reflects the fact that monetary policy changes only have an impact on the real economy with a significant lag and on inflation with an even longer lag.[2] Consequently, attempting to achieve an annual inflation target requires a more aggressive monetary policy, which may increase the volatility of the real economy and financial markets. *Second*, the independence of the central bank has been strengthened by replacing one of the outside members on the Monetary Policy Committee by the deputy governor of the Bank of Korea. In addition, the central bank's budget no longer needs the prior consent of the government, although changes in wages and benefits still require the approval of the Ministry of Finance and Economy.

Monetary conditions remain relaxed, as the central bank has left the short-term policy interest rate at a record low of 3.75 per cent since July 2003 (Figure 2.2). Adjusted for inflation, the short-term rate fell close to zero in the final quarter of 2003. The impact of interest rate declines is reinforced by the fall in the exchange rate (Figure 2.3). In contrast to many major currencies, the rate of the won relative to the dollar was relatively stable during 2003. Consequently, the won had depreciated by 10 and 16 per cent against the yen and the euro, respectively, at the end of 2003 compared to the year-earlier levels. In effective terms (relative to Korea's 41 major trading partners), the won declined 6 per cent over the same

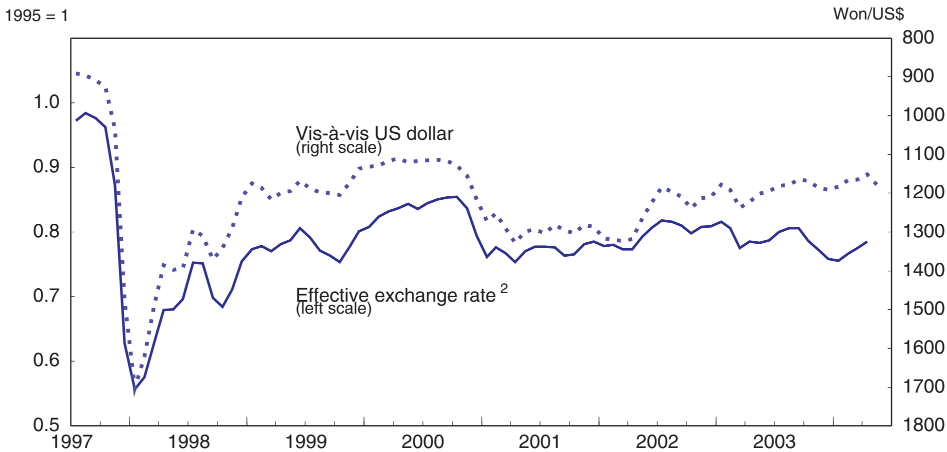
Figure 2.2. **Interest rates**



1. With a credit rating of A+ until September 2000 and a rating of AA- since October 2000.
2. Deflated by the year-on-year change in the consumer price index.
3. Rate on time deposits of less than six months.

Source: Bank of Korea.

Figure 2.3. **The exchange rate**[1]



1. A rise indicates an appreciation of the won.
2. Calculated *vis-à-vis* forty-one trading partners.

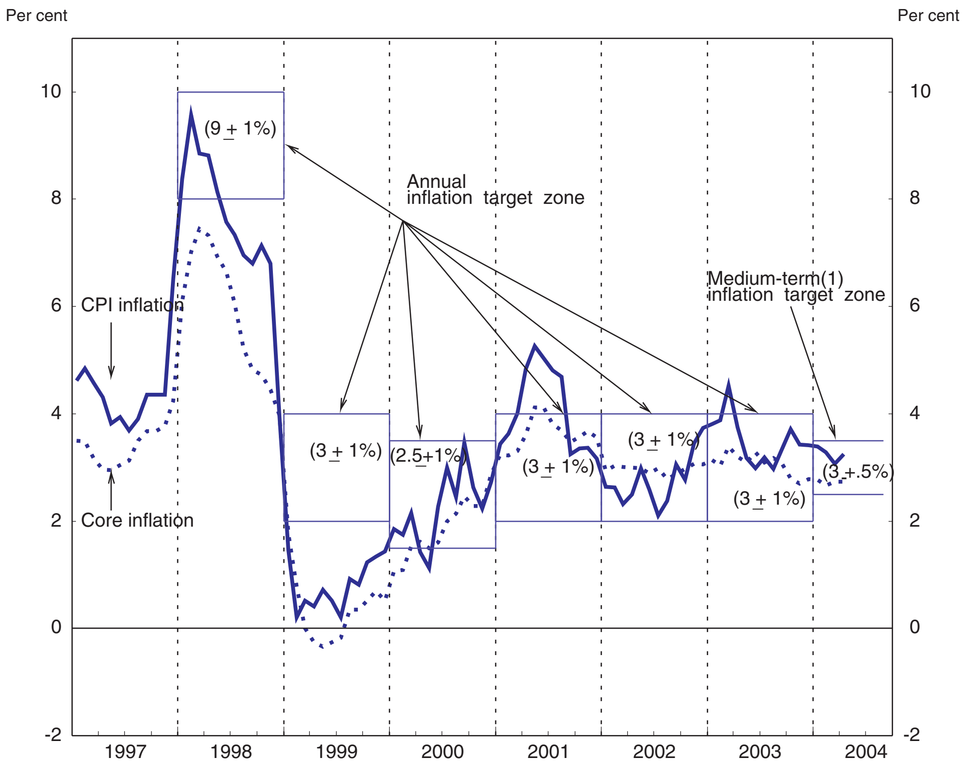
Source: OECD.

period. Part of this decline was offset by some appreciation of the won in the first quarter of 2004.

The Bank of Korea has been successful in keeping core inflation within its annual target zone since 2000 (Figure 2.4). Under the new framework, monetary policy is supposed to achieve a core inflation rate of 2.5 to 3.5 per cent over the medium term. There is concern that rising prices of oil and raw materials will have a significant impact on inflation. Indeed, producer prices in early 2004 were rising at a 4½ per cent rate, the highest in five years, which may boost the headline CPI figure above the central bank's forecast of 2.9 per cent in 2004. In response, the government recently decided to freeze public service prices – notably the tariffs for telephone, electricity and other public utilities – in the first half of 2004 and asked local governments to take similar measures. Moreover, it plans to lower mobile telecommunications fees and pharmaceutical prices in June. However, a more serious threat to inflation may come from demand pressure as the recovery accelerates, since the slack in the economy will be absorbed. During the course of the recovery, therefore, real interest rates may have to rise from their current level of close to zero in order to achieve the central bank's medium-term inflation target, although this would have a negative effect on the heavily-indebted household sector. The extent of the interest rate rise that is appropriate, though, will be affected by exchange rate developments.

Figure 2.4. **Inflation targets and outcomes**

Year-on-year percentage changes

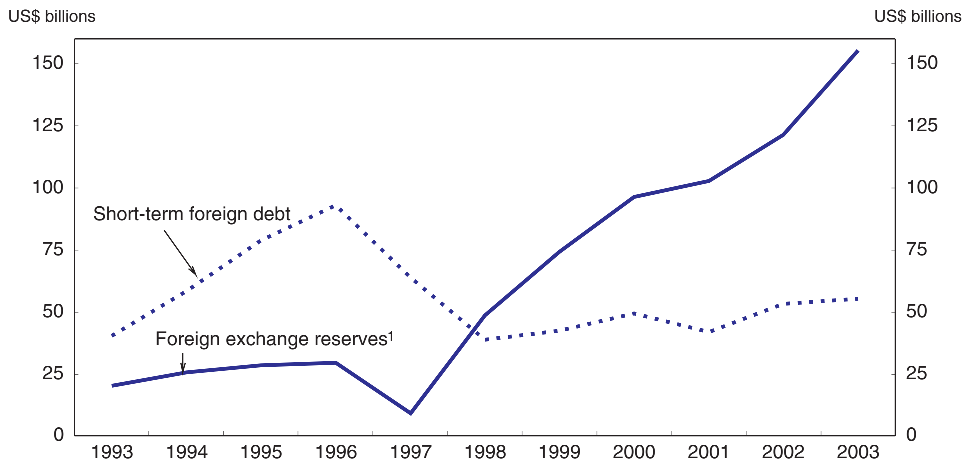


1. In 2004, the Bank of Korea changed the target to a medium-term objective.
Source: Bank of Korea.

Exchange rate policy

With an increase of $34 billion during 2003, Korea's foreign exchange reserves reached $155 billion (Figure 2.5), the second highest level in the OECD area. Consequently, reserves are now almost three times higher than short-term foreign debt, in contrast to 1997, when they were substantially less. While holding higher reserves tends to reduce vulnerability to crisis, there is little rationale from that perspective for further accumulation. The marked rise in reserves in 2003, which was significantly larger than Korea's combined surplus on the current and capital accounts, partially reflects intervention in exchange markets aimed at enhancing the

Figure 2.5. **Foreign exchange reserves and short-term foreign debt**



1. Useable reserves only, *i.e.* excludes illiquid deposits at offshore Korean banks.
Source: Bank of Korea.

stability of the exchange rate. However, there are substantial risks to a policy of intervention, which generally has limited effectiveness except in the very short run. Moreover, sterilised intervention requires the issuance of Foreign Exchange Equalisation Bonds and Monetary Stabilisation Bonds. The interest rate paid on such bonds is generally more than on the instruments in major reserve currencies.

Although slowing the pace of foreign exchange accumulation may increase the upward pressure on the won and eventually moderate export growth, there would be some offsetting positive effects. F*irst*, a stronger currency would provide income gains for households and firms. S*econd*, it would reduce the burden of the corporate sector's foreign debt, which at $70 billion in 2003 (12 per cent of GDP), is still significant. T*hird*, a stronger currency might help revive stagnant investment by lowering the price of foreign capital goods. F*ourth*, a gradual currency appreciation may impose less adjustment costs than if intervention aimed at stabilisation is followed by a significant appreciation. In sum, slowing the pace of reserve accumulation may promote a more balanced expansion over the medium term.

Real estate market considerations

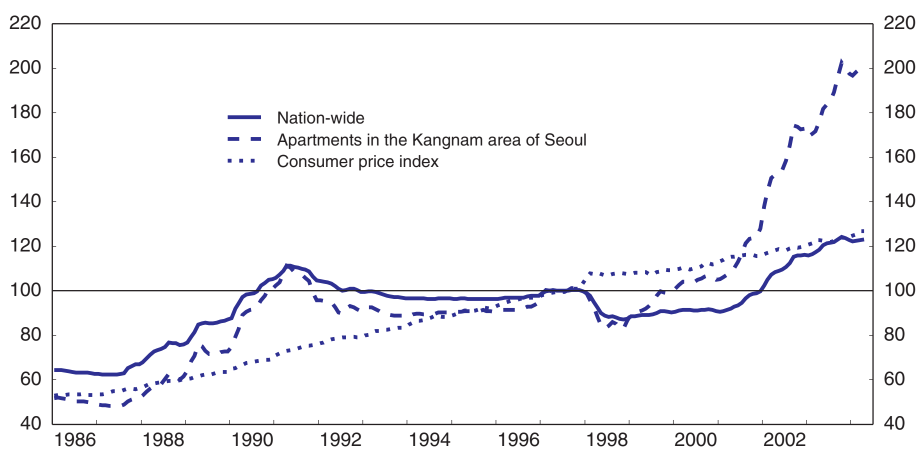
The policy of keeping interest rates at low levels has also contributed to the rise in real estate prices in recent years. High land prices have a number of adverse impacts, including distortions in the distribution of wealth, high housing prices relative to income, a lack of social infrastructure, and weakened international competitiveness of corporations. Moreover, rising real estate prices may have contributed to the private consumption boom by raising households' collateral and hence their ability to borrow. Given the consequences for price stability, real estate price trends have become a factor influencing monetary policy decisions, not only in Korea but in other OECD countries that have experienced marked increases in housing prices. Preventing higher real estate prices has been used in the past as a rationale for tighter monetary policy in Korea.

However, rising real estate prices in Korea can be attributed to a number of other factors, such as government policies that limit the use of land, thereby restricting its effective supply, and the low rate of holding taxes on real estate. Moreover, the surge in housing prices during the past few years reflects, in part, a correction from the post-crisis decline (Figure 2.6). From a longer-term perspective, the nation-wide level of house prices has kept pace with the consumer price index. Perhaps most importantly, the recent increasing trend differs from previous episodes because it is highly concentrated in the capital region, in particular, Kangnam, an area in the southern part of Seoul.

The surge in house prices appears to have been at least temporarily subdued, as the recent moderation in price movements is larger than expected based

Figure 2.6. **Housing price trends**

1997 = 100



Source: Kookmin Bank.

on seasonal factors alone. The sluggish domestic economy and the slowdown in the growth of household credits have probably had an impact. In addition, government measures to expand the housing supply and discourage speculation have helped restore stability. Following a number of *ad hoc* measures over the past few years, the government announced in October 2003 a comprehensive policy package.[3] However, maintaining stability in real estate markets will be difficult in the face of population concentration in the capital region, resulting in a shortage of housing.[4] The plan to move the capital from Seoul to the middle of the country could alleviate the concentration of activity in the capital region (see Chapter 5). However, government policy should go beyond trying to maintain stability and aim at encouraging the efficient use of land and removing regulations that tend to restrict economic activity. In sum, the localised nature of the rise in real estate prices does not suggest that a monetary policy response is needed at the present time.

Fiscal policy directions

This section briefly considers the stance of fiscal policy in 2003 and the impact on public debt. After looking at indicators of the fiscal stance for 2004, this section will discuss longer-term spending pressures stemming from the impact of population ageing on pension outlays.

Did fiscal policy help to stabilise the economy in 2003?

The impact of fiscal policy on economic activity in Korea is relatively weak, reflecting the small size of the government and the early stage of development of the social safety net. Consequently, automatic stabilisers appear to play a minor role. In 2003, two supplementary budgets in the latter part of the year boosted total government spending by 6½ per cent,[5] somewhat faster than the 5½ per cent rise in nominal GDP. However, government revenue increased even faster, at 8 per cent, due in part to a rise in corporate income tax payments.

The overall measure of the consolidated budget balance, which shows a decline in the surplus from 3.3 per cent of GDP in 2002 to 1.1 per cent in 2003, would suggest an expansionary stance (Table 2.2). However, the reported deterioration was due to special factors. Most important was the decision to replace government-guaranteed borrowing used to finance restructuring of the financial sector with public bonds (see Chapter 4). Between 2003 and 2006, 49 trillion won (6.8 per cent of GDP) of such debt is being brought into the budget. The first tranche of 13 trillion won in 2003 reduced the budget balance by 1.8 percentage points of GDP. A second special factor was privatisation revenue. The sale of Korea Telecom in 2002 had generated revenue of about 1 per cent of GDP. The decline in privatisation revenue in 2003 accounted for 0.8 percentage point of the decline in the budget surplus. In sum, two special factors – financial-sector restructuring costs and the privatisation of Korea Telecom – more than accounted for the

Table 2.2. **Consolidated government budget**

Trillion won[1]

	1998	1999	2000	2001		2002		2003		2004
	Outcomes			Initial budget[2]	Outcome[3]	Initial budget[2]	Outcome[3]	Initial budget[2]	Outcome[3]	Initial budget[2]
A. Total										
Revenue	96.7	107.9	135.8	142.1	144.0	154.4	158.7	172.0	172.2	185.3
Growth (per cent)	–2.6	11.6	25.9	4.6	6.1	8.7	10.2	11.3	8.5	7.8
Per cent of GDP	20.0	20.4	23.5	22.8	23.1	22.6	23.2	23.8	23.9	23.8
Expenditures	115.4	121.0	129.3	142.5	136.8	148.4	136.0	165.3	164.1	178.2
Growth (per cent)	15.1	4.9	6.9	5.4	5.8	4.1	1.3	11.4	20.7	7.8
Per cent of GDP	23.8	22.9	22.3	22.9	22.0	21.7	19.9	22.9	22.8	22.9
Balance	**–18.7**	**–13.1**	**6.5**	**–0.4**	**7.2**	**6.0**	**22.7**	**6.6**	**8.1**	**7.1**
Per cent of GDP	**–3.9**	**–2.5**	**1.1**	**–0.1**	**1.2**	**0.9**	**3.3**	**0.9**	**1.1**	**0.9**
Of *which*:										
Social security balance	6.0	7.3	12.5	13.2	15.4	14.4	17.6	19.4	19.6	22.5
Per cent of GDP	1.2	1.4	2.2	2.1	2.5	2.1	2.6	2.7	2.7	2.9
Privatisation revenues	0.3	3.3	0.0	3.0	3.7	5.4	6.7	1.6	1.3	–
Per cent of GDP	0.1	0.6	0.0	0.5	0.6	0.8	1.0	0.2	0.2	–
Financial-sector restructuring costs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	13.0	13.0	12.0
Per cent of GDP	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.8	1.8	1.5
B. Alternative measures of the balance										
Excluding social security	–24.8	–20.4	–6.0	–13.0	–8.2	–8.4	5.1	–12.8	–11.5	–15.5
Per cent of GDP	–5.1	–3.9	–1.0	–2.1	–1.3	–1.2	0.7	–1.8	–1.6	–2.0
Excluding financial-sector restructuring costs and privatisation revenues	–19.5	–16.4	6.5	–3.4	3.5	0.6	16.0	18.3	20.8	19.1
Per cent of GDP	–4.1	–3.1	1.1	–0.6	0.6	0.1	2.3	2.5	2.7	2.4
Excluding social security, privatisation and financial sector restructuring costs	–25.1	23.8	–6.0	–16.1	–11.9	–13.8	–1.6	–1.4	0.2	–3.5
Per cent of GDP	–5.2	–4.5	–1.0	–2.6	–1.9	–2.0	–0.2	–0.2	0.0	–0.4
Memorandum item										
Adjusted expenditures[4]	116.2	124.3	129.3	145.5	140.5	153.8	142.7	153.9	151.9	166.2
Growth (per cent)	15.9	7.0	4.0	4.2	8.7	5.7	1.6	0.1	6.4	8.0

1. On a GFS basis. Includes public enterprises, but excludes local government.
2. Growth rate relative to previous year's initial budget.
3. Growth rate relative to previous year's outcome.
4. Excludes financial sector restructuring costs and privatisation revenues, which are treated as negative net lending under the Government Financial Statistics (GFS) methodology.

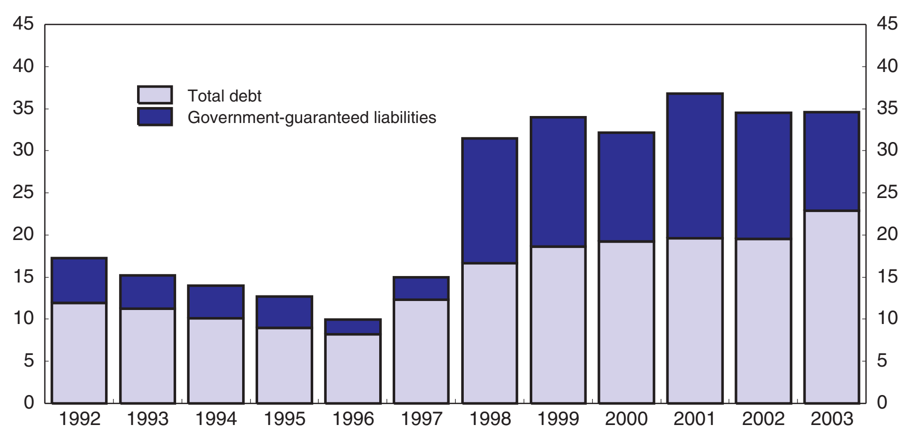
Source: Ministry of Planning and Budget.

2¼ percentage-point fall in the surplus. Excluding the financial-sector restructuring costs and privatisation receipts, the budget surplus increased from 2.3 to 2.7 per cent of GDP in 2003, implying a small contractionary effect from the government sector.

The government's preferred fiscal measure excludes the social security surplus, since this is intended to cover the future liability of pension spending. According to this measure, and adjusted for the two special factors discussed above, the consolidated budget (shown in the bottom line of Panel B in Table 2.2) was in balance in 2003 for the first time since the 1997 crisis. The elimination of the small deficit of ¼ per cent of GDP in 2002 in the context of the sharp slowdown in economic growth also suggests that the stance of fiscal policy in 2003 was contractionary.

This fiscal stance kept the total of general government gross debt, which includes local government, and government-guaranteed debt at about 34 per cent of GDP in 2003 (Figure 2.7). Even this combined amount is less than half of the 74 per cent average for gross government debt in the OECD area. Korea's gross debt did increase somewhat – from 19.5 per cent of GDP in 2002 to 23.0 per cent in 2003 (Table 2.3) – but this was offset by the fall in government-guaranteed debt related to financial-sector restructuring, as noted above. Meanwhile, the

Figure 2.7. **Government gross debt and guaranteed liabilities**
Per cent of GDP[1]



1. Intra-government debt is netted out beginning in 1997.
Source: Ministry of Finance and Economy.

Table 2.3. **Gross government debt and guarantees**

Trillion won at the end of the year

	1997	Per cent of GDP	2000	2001	2002	2003	Per cent of GDP
Total debt (A + B – C)	**60.3**	**12.3**	**111.4**	**122.1**	**133.6**	**165.7**	**23.0**
A. Central government	50.5	10.3	100.9	113.1	126.6	158.8	22.0
Borrowing	18.5	3.8	21.9	22.5	20.7	15.8	2.2
Domestic	3.2	0.7	1.9	2.1	2.3	3.2	0.3
Foreign	15.3	3.1	20.0	20.4	18.4	12.6	1.7
Bonds	28.6	5.8	76.3	87.8	103.1	140.6	19.5
Treasury	6.3	1.3	42.6	50.9	55.6	81.5	11.3
Foreign exchange	4.2	0.9	13.5	14.1	20.7	28.5	4.0
Grain security	5.1	1.0	2.5	2.1	1.1	0.6	0.1
National housing	13.0	2.6	17.8	20.6	25.7	30.1	4.2
Contract authorisation	3.4	0.7	2.7	2.8	2.8	2.4	0.3
B. Local government	15.1	3.1	22.3	21.3	19.5	18.4	2.6
C. Inter-government debt	5.3	1.1	11.9	12.3	12.5	11.6	1.6
Government guarantees[1]	**13.0**	**2.6**	**74.6**	**106.8**	**102.5**	**80.6**	**11.2**
Guarantees on loans	2.2	0.4	6.2	9.2	7.0	3.2	0.4
Domestic	0.7	0.1	2.4	5.8	5.3	1.7	0.2
Foreign	1.5	0.3	3.8	3.4	1.7	1.5	0.2
Guarantees on bonds	10.9	2.2	68.4	97.5	95.4	77.4	10.7
Of which for financial sector restructuring	7.0	1.4	68.2	97.4	95.3	77.4	10.7
Total debt plus government guarantees	**73.3**	**14.9**	**186.0**	**228.9**	**236.1**	**246.3**	**34.1**

1. Includes only central government.

Source: Ministry of Finance and Economy.

government has accumulated a substantial stock of assets, making Korea one of only three OECD countries, along with Norway and Finland, in which the government is a net creditor.

The fiscal stance in 2004

For 2004, the stance of the initial budget appears to be neutral. The increase in consolidated central government expenditures, excluding financial-sector restructuring costs and privatisation, is set at 8 per cent, roughly in line with the expected increase in nominal GDP (Table 2.2). The largest spending increases are planned for R&D investment, as part of the objective of boosting such outlays to 5 per cent of total government outlays, and social welfare expenditures as part of the development of the social safety net (Table 2.4). Total outlays are held down by significant declines planned for foreign affairs and reunification, promotion of exports and small and medium-sized enterprises, the environment and social infrastructure and housing. The increase in spending is to be matched by an 8 per

Table 2.4. **Central government expenditures**

Trillion won[1]

	2002	Percentage increase	2003[3]	Percentage increase	2004	Percentage increase
Education	22.5	12.5	24.9	9.6	26.4	5.9
Civil service salaries	20.8	9.9	22.6	8.6	24.3	7.1
National defence	16.4	6.5	17.5	6.7	18.9	8.1
Social infrastructure and housing	16.0	7.5	18.3	14.3	17.3	–5.4
Agriculture and fisheries	10.0	1.0	10.4	4.0	10.6	1.5
Social welfare	10.0	22.7	11.1	11.0	12.1	8.4
Interest payments[2]	1.8	–11.6	1.8	–1.3	1.8	3.3
R&D investment in science and technology	5.0	16.1	5.6	12	6.1	8.5
Promotion of exports and SMEs	3.6	10.1	3.9	8.3	3.6	–7.6
Environment	2.9	8.5	3.3	13.8	3.1	–6.3
Information technology	1.6	9.7	1.7	4.4	1.7	1.0
Culture, tourism and sports	1.4	12.5	1.4	2.0	1.5	3.2
Foreign affairs and reunification	0.8	4.6	0.7	–16.8	0.6	–13.2

1. Includes the initial budgets for the general and special accounts.
2. Does not include the interest payments on government-guaranteed bonds issued to pay for financial-sector restructuring.
3. Includes supplementary budgets.

Source: Ministry of Planning and Budget.

cent rise in government revenue, led by a large expected hike in social security contributions (Table 2.5). However, this does not take into account the plans announced in March 2004 to promote consumption by temporarily cutting excise taxes to encourage purchases of cars and household appliances and reducing taxes on new enterprises to promote job creation.

The impact of population ageing on public expenditures

Families remain the main source of support for the elderly in Korea. However, increased urbanisation, smaller families, a changing role for women and a marked increase in life expectancy have had a significant impact on the traditional support system. Another form of support for the elderly is the lump-sum "retirement allowance" that firms pay regular employees when they leave. However, only a third of the labour force is covered by this allowance, which moreover is often used for purposes other than retirement saving. To provide a more secure source of retirement income, the partially-funded National Pension Scheme (NPS) was established in 1988 and will begin paying regular pensions in 2008. The NPS promises to pay a replacement rate of 60 per cent for workers with 40 years of contributions who earned the average wage. However, with the current contribution rate set at 9 per cent, the NPS would have large deficits beginning in 2030 that would exhaust the National Pension Fund by 2047.

Table 2.5. **Consolidated government revenue**

Trillion won

	2002 initial budget	2002 outcome	Percentage change[1]	2003 initial budget	2003 Outcome	Percentage change[2]	2004 Initial budget	Percentage change[3]
Total tax revenue	103.7	104.0	7.9	113.8	114.7	10.3	122.1	6.8
Income, profits and capital gains	36.3	38.4	7.3	41.8	46.4	20.8	45.6	8.3
Income tax	20.1	19.2	2.6	20.2	20.8	8.3	22.0	8.2
Corporation tax	16.1	19.2	11.5	21.6	25.6	33.3	23.6	8.5
Taxes on property	3.2	2.9	0.0	3.3	2.9	0.0	3.0	–10.0
Taxes on goods and services[4]	49.2	48.0	8.8	52.8	50.9	6.0	57.3	7.9
Custom duties	7.3	6.6	10.6	7.2	6.8	3.0	7.5	4.0
Others	7.7	8.0	6.3	8.7	7.7	–3.8	8.8	1.1
Social security contributions	18.2	19.7	11.2	20.9	20.7	5.1	24.8	15.7
Non-tax revenue	30.9	33.5	12.2	35.8	35.4	5.7	37.0	3.2
Capital revenue	1.7	1.5	13.3	1.5	1.4	–6.7	1.4	–7.1
Total revenue	**154.4**	**158.7**	**9.3**	**172.0**	**172.2**	**8.5**	**185.3**	**7.8**
Per cent of GDP	22.6	23.2		23.8	23.9		23.8	

1. Relative to the 2001 budget outcome.
2. Relative to the 2002 budget outcome.
3. Relative to the 2003 initial budget.
4. Includes value added tax, liquor tax, special consumption tax and transportation tax.

Source: Ministry of Planning and Budget.

With the population ageing more rapidly than in other countries, the projected rise in pension outlays over the coming decades will be one of the largest in the OECD area. Nonetheless, the resulting level of outlays would still be below the current level of pension spending in some other OECD countries. Ensuring the long-term sustainability of the NPS requires a doubling of contributions, a halving of benefits or some combination of the two. The government is legally required to review the sustainability of the NPS every five years. Following the review in 2003, the government proposed cutting the replacement rate from 60 to 50 per cent in 2008, while ensuring the vested rights earned prior to the reform. The contribution rate would be raised by 1.38 percentage points every five years beginning in 2010, boosting it to 15.9 per cent by 2030. Such a contribution would ensure the financial sustainability – defined as a reserve fund large enough to pay two years' of benefits – through 2070. However, the National Assembly has not approved the proposed reform.

The government also introduced a bill to create a corporate pension system following two years of discussion in the Tripartite Commission. The main elements of the proposed system are:

- It will provide benefits equivalent to those paid by the retirement allowance, which mandates one month of pay for each year of employment.
- The decision of whether to maintain the allowance or move to the corporate pension system will be left to workers and management at individual firms, although tax incentives will encourage the adoption of the corporate pension system.
- The decision of whether it should be a defined benefit or a defined contribution scheme will be left to individual workplaces.
- The pension will be based on individual accounts, thus allowing portability for workers who change firms.
- The coverage of the retirement allowance, which is currently limited to regular workers in firms with at least five workers, will be gradually extended to all firms and to temporary workers. The corporate pension system would thus become potentially available to all employees.
- Employers and retirement pension providers will be required to take responsibility for the sound operation of pension reserve funds, with supervision entrusted to a special organisation such as the Financial Supervisory Service.

However, the lack of consensus has delayed the introduction of the new system. Management opposes the extension of the system to small firms and favours a defined contribution system, while labour favours a defined benefit system.

Reform of the budgetary and tax systems

Although Korea has a tradition of fiscal prudence, generally avoiding budget deficits and keeping public debt at one of the lowest levels relative to GDP among OECD countries, the expected increase in demand for spending due to population ageing and the cost of co-operation with the North calls for further improvement in the efficiency of public spending. The extensive discussion of this issue in the 2003 OECD *Economic Survey of Korea* concluded with a comprehensive set of policy recommendations aimed at improving the management of public expenditures. This section follows up the recent progress in public expenditure reform, mainly focusing on the budgetary system. Even with an improved public expenditure system, increased government revenues will be needed to cover higher outlays. It is thus important to remove the distortions in the tax system before higher government revenues substantially boost deadweight costs. The status of tax reform, the special topic of the 2000 OECD *Economic Survey of Korea*, is briefly reviewed at the end of this section.

Improving the public expenditure system

One of the major deficiencies in the current system has been the lack of strategic prioritisation in allocating budgetary resources. Given the absence of a strong linkage between the medium-term fiscal plan and the annual budgeting process, as well as the bottom-up approach based on requests of line ministries, the budget formulation process tends to be geared to a single fiscal year, resulting in weak prioritisation of resources. However, some progress has been made in strengthening the medium-term framework by building on the first medium-term fiscal plan, which covered 1999 to 2003. A new medium-term plan for the years 2004 to 2008 will be finalised after discussions at the Cabinet Council in June and July 2004 (Table 2.6). It will differ from the earlier plan by including forecasts of fiscal objectives and will be linked to a top-down budgeting process, an approach that was already introduced in four government organisations in 2004. The new plan is expected to be used as a guideline for budget requests in 2005. However, the key to an effective medium-term plan is its power to bind the annual budgeting process, which remains uncertain in the new plan. Beginning in June, the plan will be updated to 2005 to 2009 and will be used in the formulation of the 2006 budget.

Performance-based management and accountability for results

In addition to greater reliance on a medium-term budget plan, the managerial flexibility of ministries in budgeting is also being enhanced by the introduction of a performance-based management system and the establishment of executive agencies. By 2003, 22 of 54 government organisations had been selected to conduct pilot projects for performance-based budgeting. These organisations

Table 2.6. **Changes in the medium-term fiscal framework**

	Medium-Term Fiscal Plan 1999-2003	National Fiscal Management Plan 2004-2008
Scope:	Budget, focusing on the general account	Consolidated budget, including public funds
Objective:	Setting broad directions	Presenting medium-term quantitative goals, overall directions, detailed resource allocation plans
Effectiveness:	Only a reference	Reflected in actual budget formulation and Public Fund Management Plans
Method:	Centred on the MPB	Broad participation of interested parties, including related ministries
Public announcement:	Used as internal information	Publicly announced to the press after reporting to the Cabinet Council
Revisions:	Revised only when necessary	Updated every year

Source: Ministry of Planning and Budget.

are required to apply this approach to all of their fiscal projects by the end of 2004. The evaluation results based on performance indexes are to be effectively linked to fiscal management beginning in 2005. Other government organisations are also required to introduce performance-based management systems by 2005. To increase managerial flexibility in providing public services, the government established 23 executive agencies by 2001 in fields where the introduction of competition was expected to boost efficiency. In exchange for operational independence, executive agencies bear responsibility for their performance. According to evaluations by outside experts, the implementation of the executive agency system has led to an improved operational performance by those agencies, in particular by increasing self-generated revenue, producing budget savings and providing higher quality public services and greater customer satisfaction.[6]

The introduction of greater autonomy in implementing the budget should be accompanied by stronger accountability for results through systematic *ex ante*, intermediate and *ex post* spending reviews and effective value-for-money audits. As for *ex ante* project evaluation, the establishment of an independent organisation in 1999 to conduct preliminary feasibility studies for large-scale public investment projects is a major step forward. Assigning this role to the Public Investment Management Centre (PIMA), which is located in the Korea Development Institute, ensures the objectivity of the feasibility studies, in contrast to the past, when the studies were conducted by the ministries responsible for the projects. Of the 153 projects examined by 2003, 78 were suspended (Table 2.7), resulting in budget savings estimated at around 55 trillion won (8 per cent of GDP). Given the

Table 2.7. **Preliminary feasibility studies on public investment projects**
Trillion won

	Total public investment projects		Selected for screening by PIMA[1]		Investment projects rejected	
	Number of cases	Estimated expenses	Number of cases	Estimated expenses	Number of cases	Estimated expenses
1999	19	26.7	12	6.9	7	19.8
2000	30	13.9	15	6.0	15	7.9
2001	41	19.8	14	6.4	27	13.3
2002	30	16.6	13	6.2	17	10.4
2003	33	21.5	21	17.5	12	4.0
Total	**153**	**98.4**	**75**	**43.0**	**78**	**55.4**

1. The Public Investment Management Centre, which is located in the Korea Development Institute.
Source: Ministry of Planning and Budget (2002).

success of this approach in eliminating wasteful investment projects, it should be expanded to other areas such as R&D and large-scale procurement. As for intermediate spending reviews of on-going projects, the "project ceiling budget management system" for multi-year projects adopted in 1994 did not immediately help to limit mid-project increases in costs. To bind costs to the project ceiling more effectively, a number of steps were taken in 1999, including establishing a government body exclusively responsible for the ceiling (the Budget Management Bureau), requiring the signatures of individuals involved in projects, and introducing inspections to check wages and unit prices. These steps significantly reduced the gap between *ex ante* budget allocation and *ex post* costs (Table 2.8).

In contrast, the adoption of systematic *ex post* review of projects and value-for-money auditing remains at an early stage. The government has just begun to develop *ex post* evaluation techniques for special areas such as R&D, job training and state-owned enterprises. Although the Board of Audit and Inspection (BAI) is

Table 2.8. **Intermediate spending reviews**
Trillion won

	1997	1998	1999	2000	2001	2002	2003
Number of projects	70	104	194	196	169	236	306
Requested increase in cost relative to initial plan	5.2	19.1	15.4	5.5	1.7	2.7	2.0
As a per cent of total cost	20.2	28.0	19.3	7.4	3.8	3.7	2.8
Approved adjustment in cost	2.6	8.5	6.9	2.6	0.1	0.2	0.1
As a per cent of total cost	10.0	12.5	8.6	3.4	0.3	0.2	0.1

Source: Ministry of Planning and Budget.

also trying to expand its scope by focusing more on *ex post* performance audits, human resource constraints have hampered this shift. However, the BAI has recently stepped up its efforts to increase its human resources.

Increasing transparency

Further progress has been made in increasing the transparency of the budget system. As noted in previous *Surveys*, Korea's budget structure is highly fragmented and compartmentalised due to numerous special accounts and public funds that are outside of the general account. This significantly reduces the transparency of the budget system and weakens control over public spending. The special accounts and the public funds are independently managed and their funding, which involves complicated financial transfers between them, are linked to earmarked taxes and so-called "quasi-taxes" (charges and contributions not imposed by the tax laws). Moreover, the extra-budgetary funds, many of which are excluded from the national budget, are involved in quasi-fiscal activities such as financial-sector restructuring, thus further complicating the management of overall public finances. A major step forward in this area was making the public funds subject to parliamentary approval beginning with the 2003 budget process. A number of extra-budgetary funds, excluding those related to financial activities, have also been consolidated and transformed into public funds, making them subject to the same regulations and fiscal discipline. The discretion of the responsible minister in increasing the outlay of a public fund without the consent of the National Assembly was reduced from 50 to 30 per cent.

The government has consolidated or abolished public funds whose objectives are overlapping or have already been achieved. Consequently, their number was reduced from 75 in 1997 to 55 in 2004, of which nine were extra-budgetary financial funds. A key to the consolidation of public funds was the introduction of comprehensive reviews of their operations beginning in 1999. The reviews are conducted by a Fund Operation Evaluation Team consisting of 40 private specialists and the results are reported to the Cabinet Council, which, in turn, submits them to the National Assembly. Public funds are also required to have monitoring standards and procedures comparable to those for the national budget, such as quarterly funding plans, progress reports, preliminary feasibility studies and project ceiling budgeting. In addition, plans to create new public funds will be subject to more scrutiny. In contrast to the decline in public funds, the number of special accounts has remained constant at around 22, as the consolidation or elimination of special accounts was offset by the establishment of new ones. The government is considering legislation to tighten the conditions necessary for the creation of new special accounts.

Improving the efficiency of the broader public sector

Given the important role of public corporations, the government has made a significant effort to improve their efficiency and to introduce accountability mechanisms. One approach has been to reform the regulatory framework in network industries with public monopolies in order to introduce more competitive pressures (see Chapter 5). Another strategy is privatisation; by 2002, the government had sold eight of the 11 state-owned enterprises (SOEs) identified in the 1998 plan and the phased privatisation is continuing for the remaining three enterprises (the Korea Electric Power Corporation, the Korea Gas Corporation and the Korea District Heating Company). At the same time, the government planned to dispose of the 82 subsidiaries of the 18 SOEs, except for five that have a strong public nature, such as nuclear energy. As of December 2002, 50 had been restructured and 16 liquidated or merged, while 11 have remained unsold due to the lack of suitable buyers. A major impediment to privatisation is the concern about the security of public services and the possible impact on employment, which has provoked protests by labour unions. To improve the efficiency of the SOEs, some of their activities have been delegated to the private sector following the management innovation plan adopted in 1998. The number of such cases reached 289 by mid-2002. The governance problems of public corporations have also been improved by requiring them to produce financial statements and audit reports, while bonus payments at the corporations are linked to management performance assessments conducted by a committee at the Ministry of Planning and Budget.

Despite the efforts to accelerate fiscal decentralisation and devolution of power to local governments, poorly designed incentive structures in transfers from central to local governments and ill-defined spending and financing responsibilities across layers of government have resulted in inefficiency in spending and allocation of funds. Such problems are related to the complex rules for distributing equalisation transfers and the continuing dependence on conditional grants, which distort the incentives of local governments. The latter results from the lack of clear rules for co-financing and service provision between central and local governments. The reform plan under discussion by the presidential committee established in April 2003 includes:

- Introducing an across-the-board devolution of functions to local governments.
- Giving local governments more autonomy in fiscal management and expanding their resources.
- Reducing conditional grants (National Treasury Subsidies), and partially replacing them with general tax transfers (Local Share Taxes), which will be simplified.
- Improving the accountability of local governments by strengthening the Local Fiscal Management Evaluation System.

Improving the tax system

The government has introduced measures to broaden tax bases and to promote efficient resource allocation. To improve taxation of the self-employed, the income assessment method was fundamentally changed in 2002 by requiring proof of tax deductions, and a new system for issuing receipts for cash payment is to be introduced by 2005. The government has also broadened the corporate tax base by reducing or streamlining tax incentives deemed to be inefficient, many of which are related to small and medium-sized enterprises (SMEs). For example, the tax deductibility of investment reserves for SMEs has been abolished, while the tax credit ratio for SMEs was lowered from 30 to 15 per cent of the tax base and the eligibility period was shortened. The tax base of the VAT has been significantly broadened by reducing exemptions. The reduction in the threshold for the simplified tax regime for small businesses lowered the proportion of firms under this system from 90 per cent in 2001 to 46 per cent in 2003.

The government has reduced the number of tax incentives from 269 to 254 in 2003. Nevertheless, total tax expenditures, including exemptions and deductions, increased by 15 per cent in 2003 (Table 2.9). The increase is largely attributable to the incentives given to SMEs, investment and R&D. In 2004, the government introduced new incentives aimed at stimulating the economy. In particular, the reduction rate for the corporate income tax for start-ups hiring additional employees will be raised, with the minimum set at 50 per cent and the maximum at 100 per cent in July.

The government announced a plan in 2003 to reform the property holding tax, which consists of separate levies on building and land (Table 2.10). With the tax base for both set at only around 30 per cent of market value, the effective tax rate has been only 0.16 per cent (Cho and Sung, 2003). Moreover, the tax has

Table 2.9. **Trend of tax expenditure**
Billion won

	2000	2001	2002	2003[1]	Increase (per cent)
Tax expenditure (A)	13 282.4	13 729.8	14 726.1	16 883.0	14.6
Direct taxes	9 514.7	9 718.3	10 167.6	11 726.1	15.3
Indirect taxes	3 629.3	3 902.5	4 432.3	5 044.0	13.8
Tariffs	138.4	109.0	126.2	112.9	–10.5
Related tax revenues (B)	83 221.4	88 602.0	96 408.6	107 220.1	11.2
A/(A + B) (per cent)	13.8	13.4	13.3	13.6	

1. Forecast.
Source: Ministry of Finance and Economy.

Table 2.10. **Changes in the property holding tax**

	2003	2004	2005
Buildings			
Tax Base	Standard construction cost (170 thousand won/m^2)	Standard construction cost (180 thousand won/m^2)	Standard market value[1] (460 thousand won/m^2)
	Adjusted by the size	Adjusted by the market value[1]	
Tax Rate	Between 0.3 and 7 per cent		Lower tax rates
Taxation	Levied on individual building		Introduce comprehensive property tax
Land			
Tax Base	36.1 per cent "Application Ratio" to the standard market value[2]	Raise "Application Ratio" by more than 3 percentage points	50 per cent of the standard market value[2] (enforced by law)
Tax Rate	Between 0.2 and 5 per cent		
Taxation	Comprehensive land tax		Introduce comprehensive property tax

1. Surveyed by the National Tax Service.
2. Surveyed by the Ministry of Construction and Transportation.

Source: Ministry of Finance and Economy and Ministry of Home Affairs and Government Administration.

been regressive as it is adjusted for building size rather than market value. Under the new plan, the effective tax rate will be increased by raising the tax base for buildings to their full market value, while that for land will be raised to 50 per cent. In addition, the size-related adjustment will be eliminated. Finally, comprehensive taxation of an individual's property holdings will be introduced in 2005.

Reducing the number of special accounts and public funds in the government budget requires abolishing earmarked taxes and various quasi-taxes. Four earmarked taxes (Liquor, Transportation, Education and Rural Development) collected nearly 10 trillion won (10 per cent of total tax revenue) in 2002. The government postponed the planned elimination of earmarked taxes for transport and rural development-related special accounts in 2004 due to the difficulty in finding alternative revenue sources in the context of weak economic growth. These two earmarked taxes have been extended for three and ten years, respectively. The basic law on quasi-taxes, which was introduced in 2001, required that the authority responsible for collection and the purpose of the revenue must be clearly indicated. In addition, the law resulted in the consolidation of 12 quasi-taxes and placed restrictions on the introduction of new ones. Nevertheless, the number of quasi-taxes increased from 95 in 1999 to 102 in 2002, boosting the revenue collected from this source by 82 per cent during that period.[7]

Overall assessment and scope for further actions

The economy is on a recovery track led by external demand. The upturn was supported by easy monetary conditions, as the central bank lowered the short-term policy interest rate to a historic low in July 2003 and the effective exchange rate declined in a context of a rapid accumulation of foreign exchange reserves. In contrast, the stance of fiscal policy was contractionary in 2003.

With the economic upturn in 2004, fiscal policy should aim at a neutral stance in 2004. Once the process of bringing the financial-sector restructuring costs into the budget is completed in 2006, the authorities should aim at a balanced budget, excluding the social security surplus, over the business cycle. As for monetary policy, it is likely that some of the monetary stimulus may need to be withdrawn over the business cycle in order to keep inflation in the medium-term target zone of 2.5 to 3.5 per cent. However, the extent of the necessary rise in interest rates will depend to some degree on exchange rate developments. Given the costs and risks associated with intervention, there is no need for continued foreign exchange accumulation now that reserves are almost three times higher than short-term foreign debt. While this may result in some upward pressure on the exchange rate, there are likely to be some offsetting positive effects. Overall, it may promote a more balanced expansion over the medium term.

The rapid pace of population ageing poses the greatest threat to fiscal sustainability over the longer term. Korea has a window of opportunity for fundamental pension reform before the National Pension Scheme begins paying regular pension benefits in 2008. The reform should aim at putting the NPS on a sustainable basis while enhancing the role of private-sector saving for retirement. *First*, the benefits and contributions of the NPS should be brought into balance, primarily by lowering the replacement rate, given the negative labour market consequences of high contribution rates. *Second*, the effective coverage of the NPS should be expanded, as a quarter of the people currently required to contribute to the Scheme do not participate. *Third*, the social benefit system should be expanded to limit poverty among the elderly until the NPS begins paying full pensions. *Fourth*, the financial imbalances in the public-sector occupational pension schemes, which are already in deficit, need to be addressed, while introducing portability with the NPS. *Fifth*, the plan to transform the retirement allowance system, which is generally unfunded by firms, into a corporate pension system should be implemented. Its success, though, will depend on adequate prudential supervision of private pension schemes.

The increased spending resulting from population ageing and the development of the social welfare system, as well as the uncertain cost of economic co-operation with North Korea (Box 2.1), make it important to improve the efficiency of the public expenditure and tax systems. On the tax side, the measures to broaden the tax base for the corporate income tax and the VAT, as well as to raise

Box 2.1. Economic co-operation between North and South Korea

The North Korean economy is estimated to have grown 1 to 2 per cent in 2003, its fifth consecutive year of growth, despite continuing shortages of food and energy. Indeed, it has faced a food shortfall each year, estimated at around 2 million tonnes, since the 1990s. Moreover, manufacturing production is estimated to be one-fifth below its 1995 level. Economic reforms in the North are continuing to shift power away from the center and towards factory managers and municipal authorities, thus helping to reduce the reliance on central planning.

Processing-on-commission trade, concentrated in the textile industry, has been boosting trade between the North and South. Two-way trade increased 13 per cent in 2003 to $724 million, with commercial exchanges accounting for a little more than half of the total. Joint projects, such as the Mount Geumgang tourism site, and humanitarian aid accounted for the remainder. For example, the South supplied the North with 0.3 million tonnes of fertilizer and 0.4 million tonnes of food in 2003. Of the commercial trade, textile and agricultural products accounted for about four-fifths of the South's imports from the North, while textiles and electronic products are its most important exports to the North. The expansion of trade in recent years would make the South the second-largest trading partner for North Korea, accounting for a third of its total trade. However, for South Korea, trade with the North amounts to only 0.2 per cent of its international trade. According to the National Statistical Office of South Korea, the South Korean economy is 28 times larger than the North's.

The eighth meeting on Inter-Korean Economic Co-operation in March 2004 focused on the development of an industrial park for South Korean firms in Kaesong, which is just north of the border. This project is of interest to South Korean firms, given the low wage level of $57 per month that will be paid to North Korean workers in the zone. However, many legal and infrastructure problems, including transport and the supply of electricity, must be settled before this industrial park can attract investors. In the second half of 2004, some 3.3 million m^2 is scheduled to be ready for South Korean firms. Road and rail links to Kaesong, financed by the South Korean government, are expected to be completed this year, while infrastructure within the industrial zone is being developed by Hyundai. The zone is eventually expected to cover 66 million m^2, with housing for North Korean workers expected to take more than half of the total. The convenient location of Kaesong may help it to be more successful than earlier attempts to establish special economic zones in North Korea, which were located in remote areas. Meanwhile, work on the Seoul-Sinuiju railroad line and on the Donghae line on the east coast is advancing with test runs expected this year. Direct transport links will help overcome the high cost and inconvenience of indirect trade through third countries.

the effective tax rate on real estate, are commendable. The priority should be to reduce the generous allowances and tax credits in the personal income tax that result in about 50 per cent of all individual income earners not paying income tax.

Although progress has been made in improving the public expenditure system, implementing best practices requires an acceleration of reform to enhance efficiency and transparency. Given the indicative nature of the existing medium-term budget framework, its linkage with the annual budget process needs to be strengthened further. The weakness of *ex post* spending review and performance auditing suggests the necessity of establishing an effective institutional framework for evaluating performance, in particular, by increasing the capacity of the Board of Audit and Inspection. Public funds and special accounts should be consolidated further based on stricter evaluation. There is also a need for tighter controls on the creation of new funds and accounts. Moreover, the ability of the responsible minister to boost the outlays of a public fund by up to 30 per cent without the consent of the National Assembly should be further narrowed. Earmarked taxes and quasi-taxes should be reduced. To improve the governance of public corporations, general accountability mechanisms need to be upgraded further by adopting more output-oriented reporting through activity-based costing and strengthening monitoring mechanisms. The government should proceed toward fiscal decentralisation by improving the incentive framework in transfers from central to local governments, while increasing the autonomy and flexibility of local governments.

Notes

1. Wage data may be over-estimated since the survey is limited to firms with more than five employees and to regular workers. Given the increasing number of lower paid non-regular workers, the actual wage hike may be somewhat less. It is clear, though, that wage growth slowed only slightly in 2003 despite the economic slowdown.
2. A change in the overnight call rate is estimated to begin to influence output two quarters later, reaching its maximum impact four to six quarters later (Yang Woo Kim, 2002). As for inflation, the impact is estimated to be felt from the third quarter, but does not reach its full effect until eight or nine quarters.
3. The main contents of this package are: 1) expanding the supply of housing by constructing new towns in northern Seoul; 2) providing better financial investment opportunities; 3) strengthening the capital gains and property holding taxes; and 4) reinforcing other regulatory measures such as tax audits and limitations on the transfer of parcelling rights.
4. The "housing supply ratio" – the ratio of the number of houses to households – has risen from 86 per cent nation-wide in 1995 to 101 per cent in 2002. In Seoul, in contrast, the ratio, though increasing in recent years, is only 82 per cent.
5. This figure excludes the cost of bringing government-guaranteed borrowing into the budget in 2003 and the impact of privatisation, which is treated as negative net lending in the GFS measure of the government budget.
6. Report by the Executive Agencies Evaluation Committee in 2002, cited in MPB (2002).
7. This reflects the creation of new non-tax payments such as the Electric Power Industry Fund and a surcharge on water usage.

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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: June 2004	Number of seats
Central government revenue, 2003, consolidated basis (per cent of GDP)	23.9	The Uri Party	152
Central government budget balance, 2003, consolidated basis (per cent of GDP)	1.1	The Grand National Party	121
		Other	26
			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.*

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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.

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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

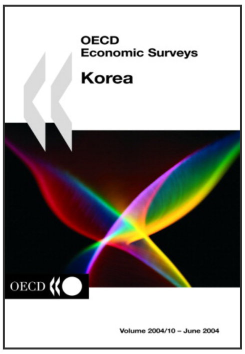
A comprehensive reform package is needed to increase employment flexibility, create more co-operative industrial relations and reduce the extent of dualism in the labour market, which creates equity concerns. Relaxing employment protection for regular workers and improving the coverage of the social 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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