Executive summary

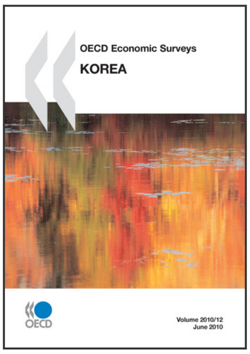
Korea's strong recovery from the 2008 global recession has been driven by buoyant export growth, due to the won's depreciation and demand from China, and an effective policy response. The fiscal stimulus was the largest in the OECD area, while monetary policy and measures to support financial institutions helped to prevent a liquidity crunch. Output is projected to grow 5¾ per cent in 2010 and 4¾ per cent in 2011, as a double-digit increase in exports leads to stronger domestic demand growth. With the recovery on track, government spending is being reduced in 2010, which is necessary if Korea is to achieve its medium-term target of cutting the fiscal deficit to close to zero by 2013 and keeping gross government debt below 40% of GDP. Meanwhile, the policy interest rate has remained at a record low of 2% for more than a year. Given the strength of the expansion, it is important to begin normalising interest rates to ensure that inflation remains within the central bank's 2% to 4% medium-term target.

Sustaining growth and rising living standards over the medium term depends on increasing labour force participation to offset population ageing and on raising labour productivity. It is important to boost women's labour force participation rate by narrowing the gender wage gap, expanding the availability of childcare and encouraging family-friendly workplaces. The high share of non-regular workers in the labour force creates serious problems for both growth and equity. It should be reduced through a comprehensive approach of reducing employment protection for regular workers and expanding social insurance coverage and training opportunities for non-regular workers. The scope for productivity gains is largest in services, where it is low compared to manufacturing, reflecting overly strict regulations that obstruct investment. The objective should be to strengthen competition by accelerating regulatory reform, upgrading competition policy and creating an environment that will attract more inflows of foreign direct investment.

Reforming the financial sector. *While financial institutions appear to have overcome the crisis without significant damage, reforms are necessary to strengthen the financial sector. Increased assistance to small and medium-sized enterprises, including measures to expand bank lending to them, should be withdrawn to avoid supporting non-viable firms. It is also important to reduce Korea's vulnerability to external shocks and improve the governance of financial institutions. The risk of excessive mortgage debt should be dealt with through appropriate limits on loan-to-value and debt-to-income ratios, while supply-side policies are needed to address longstanding concerns about housing prices in the capital region.*

Reforming health and long-term care. *The health-care system has contributed to the impressive gains in health outcomes in Korea while keeping expenditure below the OECD average. But spending is rising at a double-digit pace and rapid population ageing and the plan to expand the coverage of the National Health Insurance will increase spending pressure further. It is therefore critical to introduce efficiency-enhancing reforms, notably changing the payment system away from fee-for-service, shifting long-term care out of hospitals to less expensive care, reducing expenditures on drugs, promoting healthy ageing and introducing gatekeepers. To finance health spending, it is essential to shift toward a broader tax revenue base and away from social insurance payments,* *which will have an increasingly negative impact on the labour market as the population ages. It is important to ensure that the very high out-of-pocket payments by patients do not impede access to necessary health care for low-income households and the chronically ill. Quality should be improved by increasing transparency about patient outcomes, allowing the entry of investor-owned institutions to upgrade the hospital sector and increasing the number of physicians.*

Promoting green growth and addressing global warming. *Korea plans to make green growth the driver of economic development, while cutting greenhouse gas emissions significantly by 2020. To achieve this target in a cost-effective manner, Korea should introduce a comprehensive emissions trading system as quickly as possible. Setting a price for carbon would also encourage the development of new technologies to lower abatement costs. The spending in the Five-Year Green Growth Plan should focus in particular on basic R&D, while policies to secure new growth engines should avoid industry-specific measures as policies to "pick winners" are risky.*



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