Executive summary

Korea has been hard-hit by the commodity price shock and the global financial crisis, which have slowed economic activity and pushed up inflation. The terms-of-trade loss reduced national income, thus damping domestic demand, while the slowdown in world trade has moderated Korea's export growth. Moreover, the sharp exchange rate depreciation and the intensification of the global financial market crisis have further dimmed the outlook. Although the recent fiscal stimulus is likely to help support growth, an economic rebound depends on a recovery in the world economy. In addition to these short-term difficulties, Korea faces a number of challenges to sustaining economic growth over the medium term, notably tax reform, enhancing service sector productivity growth and reforming the labour market and education system.

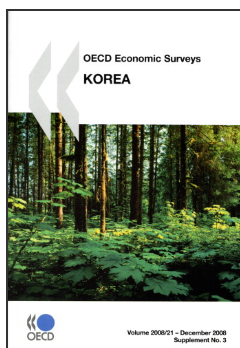
Macroeconomic policy has a difficult role to play. *In the near term, monetary policy should focus on supporting activity and financial-market stability. Foreign exchange market intervention to support the won is likely to be costly and ineffective in the face of global financial turmoil and should therefore be limited to smoothing operations. As conditions stabilise, monetary policy will need to give more weight to the risk that inflation may become entrenched well above the 2.5% to 3.5% target zone. While tax cuts and additional spending are helping cushion the downturn, fiscal policy in the medium term should focus on maintaining a strong government financial position in light of future spending pressures. Given planned tax cuts, this will call for reining in public outlays, which have grown rapidly in recent years.*

A comprehensive tax reform is essential. *Government spending is one of the lowest in the OECD area, reflecting Korea's relatively young population. However, the population is projected to age faster than in any other OECD country, putting considerable upward pressure on public expenditures in the long term. Tax reform is thus needed to meet the demand for higher revenue while, at the same time, promoting economic growth, addressing rising income inequality and relative poverty and improving the local tax system to provide more autonomy for local authorities. To achieve these goals, reform should rely primarily on higher consumption taxes and base broadening of income taxes for additional revenue, an in-work tax credit to meet distributional objectives and more use of local property-holding taxes to finance local authorities. Keeping direct tax rates low will promote growth.*

Enhancing service sector productivity is essential to sustain growth. *Weak productivity gains in services – 60% of the economy – have been a major drag on growth. Boosting productivity requires strengthening competition by accelerating regulatory reform, focusing on removing entry barriers, and upgrading competition policy. Greater openness to international competition, by improving the climate for foreign direct investment and including services in free trade agreements, would also help, as would addressing the problems in small and medium-sized enterprises. Industry-specific reforms are needed in key services, including telecommunications and financial and business services.*

Labour market and education reforms are also essential for growth. *Labour market dualism, driven by the rising share of temporary workers, has negative implications for human*

capital formation. Reducing dualism would improve efficiency and equity. To mitigate the impact of population ageing, labour force participation needs to be increased, particularly for women and youth. Expanding the availability of childcare and maternity leave is a priority for the former, while reducing dualism would promote the participation of both groups. Low youth employment rates are partly due to the mismatch between the education system and the labour market, making it important to reform all levels of education. For older workers, the age of retirement from firms should be raised by abolishing mandatory retirement, reducing the importance of seniority in setting wages and phasing out the retirement allowance.



From:
OECD Economic Surveys: Korea 2008

Access the complete publication at:
https://doi.org/10.1787/eco_surveys-kor-2008-en

Please cite this chapter as:

OECD (2008), "Executive summary", in *OECD Economic Surveys: Korea 2008*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/eco_surveys-kor-2008-2-en

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