Chapter 1

Sustaining the recovery from the global financial crisis by promoting Korea's medium-term growth potential

Korea has achieved one of the strongest recoveries among OECD countries from the 2008 global recession, led by its robust export performance and the largest fiscal stimulus among member countries. The expansion is projected to continue through 2011 as the positive impact from external demand spreads further to the domestic economy. Sustaining high growth over the medium term requires narrowing the large labour productivity gap with more advanced OECD economies through reforms, particularly in services, where productivity is low. The priority is to strengthen competition by eliminating domestic entry barriers, accelerating regulatory reform, upgrading competition policy and reducing barriers to trade and inflows of foreign direct investment. Such measures should be accompanied by reforms to reduce labour market dualism, which has negative consequences for growth and equity. In addition, it is important to increase labour force participation, notably among women and older persons, not least to mitigate the impact of population ageing.

Korea bounced back quickly and vigorously from the global economic crisis. Its outstanding performance has raised its share of world exports and its profile in the global economy, which is also boosted by its chairmanship of the G20 in 2010. This chapter begins by analysing Korea's recovery from its sharp downturn in the second half of 2008 and its short-term economic outlook. Over the longer term, sustaining high growth will be necessary to narrow the still large gap in per capita income between Korea and the most advanced OECD countries. The chapter discusses the need for reform in two areas – the non-manufacturing sector and the labour market – to sustain Korea's growth potential.

Korea's recovery from the global financial crisis

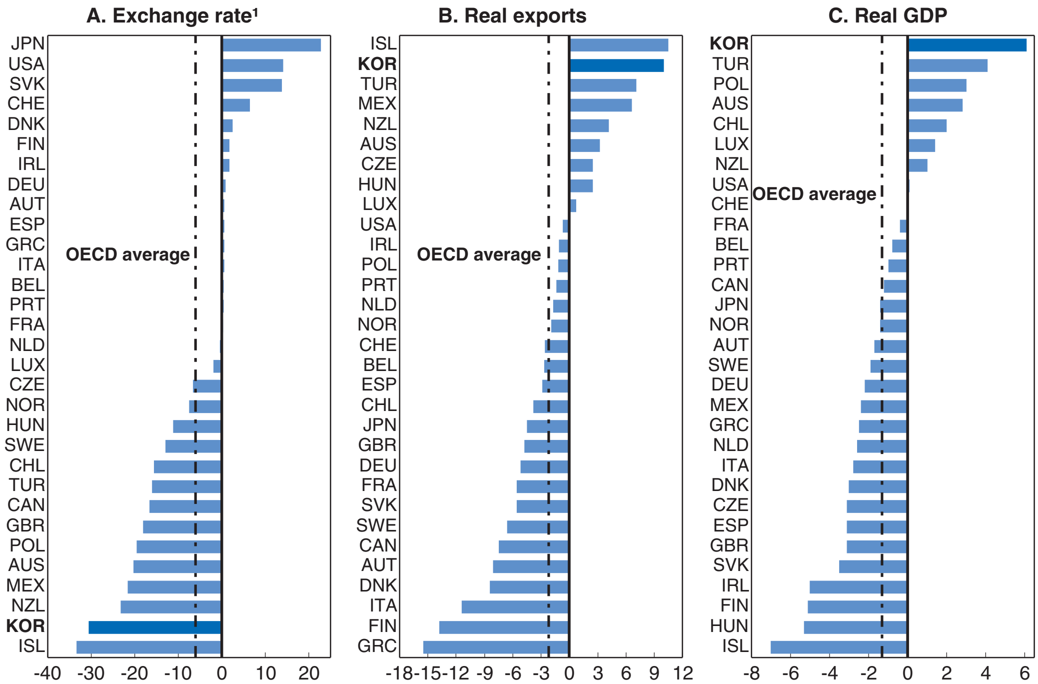
The Korean economy was already slowing prior to the intensification of the global financial crisis in September 2008, reflecting the US recession that had begun in December 2007, rising oil prices and the impact of tighter monetary policy. Although its financial sector was generally sound and had little direct exposure to the subprime problems, Korea was severely affected by the crisis. Indeed, Korea's output fell by 17% (at an annual rate) in the fourth quarter of 2008, more than double the decline in the OECD area, reflecting the collapse in world trade. Korea's export decline was particularly sharp, given its concentration in medium and high-technology products that are especially cyclically-sensitive.[1]

The sharp economic downturn in the fourth quarter of 2008 was accompanied by large outflows of foreign capital (Chapter 3). These outflows contributed to a sharp fall in equity prices and a jump in Korea's credit default swap (CDS) rate from 104 basis points in August to 699 points in October 2008, one of the highest in the OECD area. Meanwhile, risk premia soared in short-term money markets and corporate bond markets. As the capital market dried up, firms turned toward the banking sector, only to face tightening lending attitudes in the context of higher credit risks. Domestic banks, which had accumulated large external debt in the years prior to the crisis, found it difficult to roll over these loans given the global liquidity crisis. These adverse developments put additional downward pressure on the won, which by the first quarter of 2009, was 31% below its year-earlier level, the second-largest drop in the OECD after Iceland (Figure 1.1). The crisis, with large capital outflows and a sharp depreciation of the won, resembled the 1997 crisis in some respects (Annex 1.A1).

However, the sharp depreciation of the won also helped to trigger Korea's rebound by significantly improving its international competitiveness. Indeed, Korea rose from the world's 12th largest exporter in 2008 to ninth in 2009.[2] Export volumes increased 10% in the course of 2009, the second-fastest rise in the OECD area (Figure 1.1, Panel B).[3] Korea also benefited from its close trade ties with Asian countries and from the massive stimulus programme undertaken in China in 2009 (OECD, 2010c). Korea's exports to China (including Hong Kong, China) accounted for 87% of the rise in Korea's total exports over that same period (in US dollar value), boosting the share of China in Korean exports from 23% to 30%.[4]

Figure 1.1. **Korea has achieved the strongest recovery from the crisis, led by exports**

Percentage change in 2009 (4th quarter on 4th quarter)



1. Percentage change in the nominal effective exchange rate between the first quarters of 2008 and 2009, calculated *vis-à-vis* 41 trading partners.

Source: *OECD Economic Outlook Database*.

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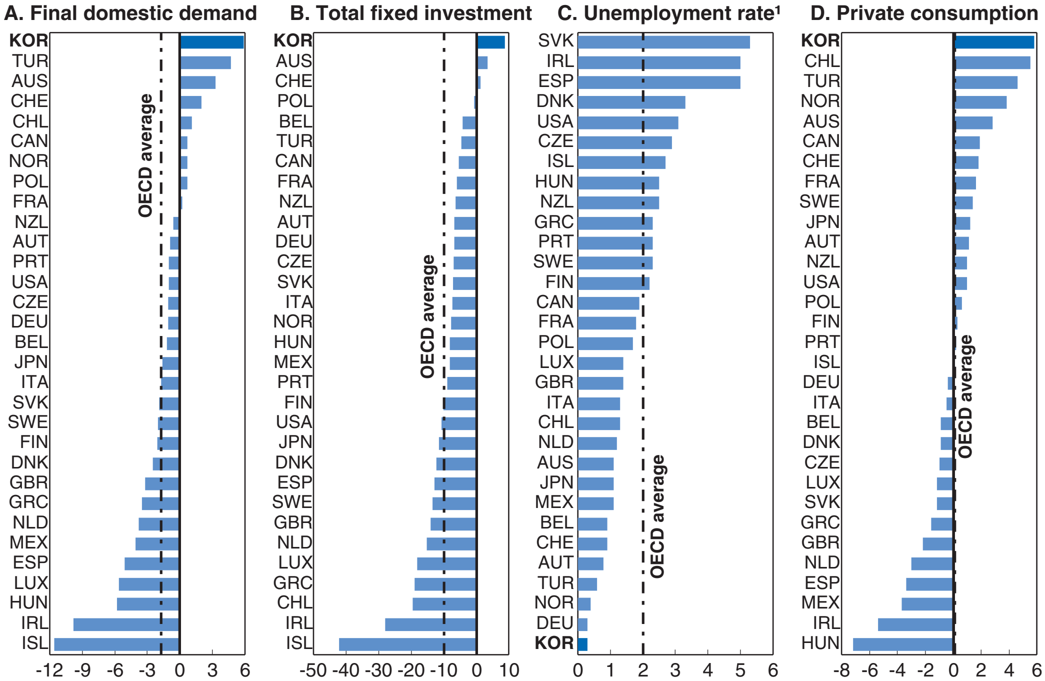
By product, export volume of semiconductors and electric appliances nearly doubled during 2009. Buoyant exports were a key factor helping Korea achieve the fastest output growth in the OECD area in the course of 2009 at 6.1% (Panel C).[5]

Strong domestic demand growth, again the fastest in the OECD area in 2009 (Figure 1.2), also played an important role in Korea's recovery, reflecting three factors. *First,* buoyant exports sustained employment and boosted investment in facilities equipment, as companies expanded production capacity. *Second,* financial market distress in Korea was relatively limited, thanks to the sound position of financial institutions prior to the crisis and an effective policy response (Chapter 3). *Third,* Korea's fiscal response was the largest among OECD countries adopting explicit crisis-driven stimulus programmes, boosting government consumption and investment (Chapter 2). Indeed, government investment increased 13% in the course of 2009, the fastest since 1996. Consequently, fixed investment growth in Korea was also the fastest in the OECD area during 2009 (Panel B), despite sluggish residential investment.

The fiscal response was particularly important in sustaining employment. The government launched the "Hope Employment Programme", providing 250 thousand jobs (1.5% of dependent employment) to vulnerable groups, as well as 99 thousand internships for new graduates. Consequently, short-term public employment increased from an average of 228 thousand in 2008 to 504 thousand in 2009,[6] more than offsetting the decline in private-sector employment. It is estimated that the unemployment rate during 2009

Figure 1.2. **Domestic demand growth was also exceptionally strong in Korea**

Percentage change in 2009 (4th quarter on 4th quarter)



1. Percentage-point increase in the unemployment rate between the fourth quarters of 2008 and 2009.

Source: *OECD Economic Outlook Database.*

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would have been 4.3% – rather than the 3.6% recorded – without the additional public jobs.[7] Thus, the rise in the unemployment rate in Korea in 2009 was well below the OECD average of 2 percentage points (Figure 1.2, Panel C), although it was kept down by a fall in the participation rate. Employment gains boosted wage income and helped to sustain private consumption growth, which was also the highest in the OECD area during 2009 (Panel D).

The strong economic recovery, coupled with effective government policies, helped to normalise financial conditions from the first quarter of 2009 (Chapter 3). The capital account returned to balance in the first quarter of 2009, followed by significant surpluses in the following quarters. By April 2010, the equity price index had rebounded about 50% since the end of 2008, thanks in part to large purchases by foreign investors, bringing it to within 17% of its 2007 peak. Increased capital inflows also boosted the won, which in the first quarter of 2010, was 20% above its year-earlier level in effective terms. Risk premia declined, although remaining above the pre-2008 level, especially for lower-rated companies, while bank lending attitudes have returned to neutral, at least for large firms. By February 2010, the CDS rate for Korea had fallen to its August 2008 level. In addition, Moody's upgraded its rating of Korean government bonds in April 2010 from A2 to A1, its pre-crisis level. Finally, corporations and financial institutions have largely overcome the global crisis without the type of damage that occurred in the wake of the 1997 crisis, which saw a large number of bankruptcies, a huge run-up in non-performing assets and a lack of capital in financial institutions that required significant injections of public money.

Korea's short-term economic outlook

Output increased by 8.8% in the first quarter of 2010 (seasonally-adjusted annual rate), the fifth consecutive quarter of positive growth. Korea's recovery is projected to remain on track, with year-average real GDP growth reaching 5¾ per cent in 2010 and easing slightly to 4¾ per cent in 2011 (Table 1.1). Exports will remain a driving force as Korea's export market growth is projected to remain strong and firms continue to benefit from a weaker won, which is still 15% below its level in early 2008. Perhaps more importantly, given the competition with Japanese products in export markets, the won is still 25% weaker relative to the yen.[8] In short, Korea is well-positioned to further expand its share of world trade. Continued export growth will stimulate business investment to increase capacity for industrial production, which is already more than 10% above its pre-crisis peak. Moreover, the Business Sentiment Index had reached its highest level since 2002 by February 2010. Business investment, though, will face some headwinds from higher risk premia on bonds and a more restrictive lending attitude toward SMEs by banks, which have seem some rise in their sub-standard loans (Chapter 3). Nevertheless, fixed investment is projected to increase 6.7% in 2010, despite a fall in public investment as fiscal stimulus is phased out and sluggish residential investment in the context of a large stock of unsold homes and strict limits on mortgage lending (Chapter 3).

Table 1.1. **Short-term economic outlook for Korea**[1]

	Share of 2008 GDP[2]	2009	2010	2011	2009[3]		2010[3]		2011[3]	
					1st half	2nd half	1st half	2nd half	1st half	2nd half
Private consumption	54.7	0.2	3.8	4.0	–0.8	7.3	2.3	3.5	4.2	4.3
Government consumption	15.3	5.0	3.4	2.3	8.4	–1.8	8.3	–0.8	3.0	4.0
Gross fixed capital formation	29.3	–0.2	6.7	5.0	–2.4	11.0	5.0	6.0	4.7	4.4
Final domestic demand	99.3	0.8	4.6	4.0	0.2	6.9	4.1	3.5	4.1	4.3
Stockbuilding[4]	1.9	–4.6	2.2	0.0	–9.5	4.2	3.0	0.0	0.0	0.0
Total domestic demand	101.2	–3.8	7.1	4.1	–9.4	11.1	7.1	3.6	4.2	4.3
Exports, goods and services	53.0	–0.8	11.1	12.6	–6.1	18.5	7.0	12.6	12.8	12.4
Imports, goods and services	54.2	–8.2	14.2	11.9	–19.1	23.4	11.7	10.9	12.0	12.4
Net exports[4]	–1.2	4.0	–1.0	0.7	7.6	–1.9	–2.2	1.0	0.6	0.2
GDP at market prices	100.0	0.2	5.8	4.7	–1.8	9.2	4.9	4.6	4.8	4.5
Memorandum items:										
Consumer price index	–	2.8	3.0	3.2	1.9	2.4	3.2	3.2	3.2	3.3
Core consumer price index	–	3.6	2.2	3.2	3.2	2.2	1.8	3.2	3.2	3.3
Unemployment rate	–	3.6	3.6	3.3	3.7	3.6	3.9	3.4	3.4	3.3
Household saving ratio[5]	–	3.6	3.5	3.8	3.8	3.3	3.5	3.5	3.7	3.9
Gross government debt[6]	–	34.9	36.2	37.4	–	–	–	–	–	–
Net government debt[6]	–	–31.0	–29.7	–28.6	–	–	–	–	–	–
Current account balance[6]	–	5.2	1.7	1.6	6.2	4.2	1.3	2.1	1.8	1.5
Exchange rate (per USD)	–	–14.8	12.0	0.1	–20.8	25.5	12.0	0.5	0.0	0.0
Export market growth[7]	–	–8.5	15.8	9.5	–21.0	18.3	18.5	8.7	9.6	9.9

1. OECD projections published in *OECD Economic Outlook*, No. 87 (May 2010), based on the exchange rate of 10 May 2010 (1 131.8 won per dollar) and oil (Brent) at USD 80 per barrel.
2. As per cent of nominal GDP.
3. Annualised growth rates.
4. Contributions to changes in real GDP.
5. As a percentage of disposable income.
6. As a percentage of GDP.
7. Weighted import growth in volume terms in Korea's trading partners.

Source: OECD (2010b), *OECD Economic Outlook*, No. 87 and Bank of Korea.

The economy will face some drag from the removal of fiscal stimulus, as government spending is slated to fall by 4.2% in 2010 from the 2009 outcome (Chapter 2). In particular, job gains will be slowed somewhat by a scaling back of the government's public employment programmes. The average number employed in these programmes is planned to fall from 504 thousand in 2009 to 389 thousand in 2010. Consequently, public employment will cut the unemployment rate by 0.4 percentage point in 2010 as against 0.7 point in 2009. However, the fall in public employment will be more than offset by private-sector job gains, particularly in the industrial sector. Indeed, manufacturing jobs increased by 1.6% (seasonally-adjusted) in the first quarter of 2010. The recovery in private-sector employment is projected to lead to a pick-up in wage growth, which was relatively sluggish in 2008-09. Increased wage income should underpin a rebound in private consumption to 4% by 2011, despite the end of the tax incentives to encourage car sales. The Consumer Sentiment Index stayed above the benchmark of 100 for a third consecutive quarter in the first quarter of 2010,[9] although it fell slightly, reflecting instability in global stock markets, fiscal problems in Europe and tightening fiscal policy in China (SERIWorld, 2010).

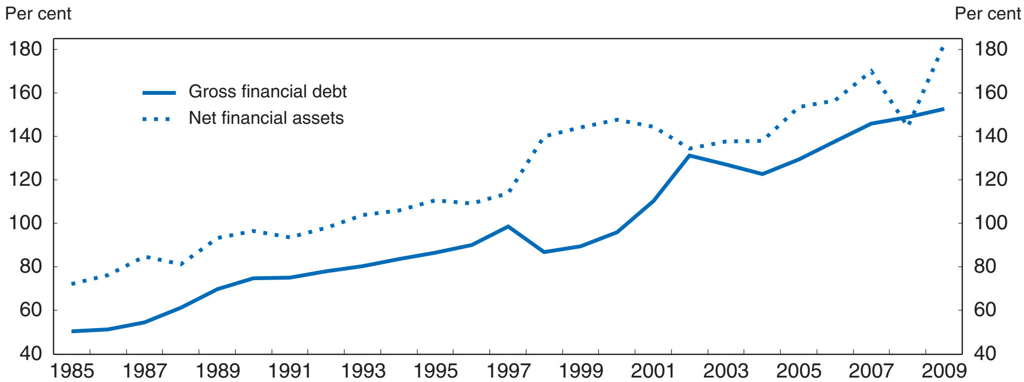
Consumer price inflation, which rose to nearly 6% (year-on-year) in mid-2008, has been brought within the Bank of Korea's target zone of 2% to 4% as a result of the significant economic slack in the wake of the crisis. Inflation bottomed out at 2% (year-on-year) in the third quarter of 2009 and has since picked up while remaining below the mid-point of the inflation target. Despite strengthening domestic demand, inflation is projected at around 3% in 2010-11, based on the assumption that the policy interest rate rises from its record low of 2% since February 2009 to 4½ per cent by the end of 2011. Meanwhile, stronger domestic demand is expected to reverse the large fall in imports in 2009, helping to reduce the current account surplus from 5.2% of GDP in 2009 to less than 2% in 2010-11.

For a major exporter like Korea, the risks to the outlook relate mainly to the world economic environment. To the extent that world trade growth departs from the 8% to 11% projected by the OECD for 2010-11, Korean output growth would be affected, as it is so sensitive to exports. Also, a large change in the value of the won would impact exports. On the domestic side, one uncertainty is the timing and pace of restructuring in the business sector and its impact on the recovery. The decision to automatically roll over bank loans to SMEs in 2009 enabled a number of non-viable firms to survive. On the upside, a continuation of the large positive contribution from stockbuilding recorded in the second half of 2009 and the first quarter of 2010 would lead to stronger growth in 2010.[10]

The most oft-cited domestic risk is household debt, which increased to 153% of disposable income (Figure 1.3), mid-way between the United States (128%) and the United Kingdom (180%). The rising debt ratio reflects a number of factors, including falling real interest rates on loans to households and the expanded use of credit cards. Most debt is at variable rates, shifting risk from financial institutions to households. However, the risk from household debt is mitigated by a number of factors. *First,* household net financial assets jumped to 182% in 2009 after a sharp fall in 2008. Thus, households have the ability to pay debt without disposing of their real estate in case of emergency. *Second,* banks have increased their loan-loss reserves from 8.4 trillion won in 2006 to 12.6 trillion won by the end of 2009, despite writing off 3 trillion won of non-performing loans in the second half of 2009, thus enhancing their ability to cope with any increase in substandard loans to the household sector. Nevertheless, there is a risk related to low-income households. Although the lowest income quintile accounts for only 5% of household debt, their share of assets was even lower at 3% in 2007 data (Table 1.2). Moreover, their debt service ratio of 28% is

Figure 1.3. **Household financial assets and liabilities**

As a per cent of household disposable income[1]



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

Source: Bank of Korea.

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2.5 times higher than for the top income quintile, making them vulnerable to higher interest rates. In addition, the high level of household debt is partly explained by business-related borrowing by the self-employed, suggesting that household debt problems could weaken business investment.[11]

Korea's growth prospects over the longer term

Income per capita in Korea has converged from less than one-half of the benchmark of the average of the upper half of OECD countries in 1991 to two-thirds in 2008 (Figure 1.4). Nevertheless, the gap remains wide despite the large contribution from labour inputs, which were one-third above the benchmark. Consequently, labour productivity per hour worked in Korea is only one-half of the benchmark. Looking ahead, the convergence process will face headwinds from declines in labour inputs, which will tend to slow potential growth from its rate of above 4% in the early 2010s, according to OECD estimates. Indeed, working hours, which have been falling at a 1.5% annual rate since 2000, are likely to continue declining from 2 256 hours per year in 2008 toward the OECD average. In addition, the Korean population is set to age more rapidly than in most OECD countries, with a projected doubling of the share of persons over the age of 65 from 7% in 2000 to 14% by 2018. Sustaining the momentum of convergence to the per capita income levels in the most advanced countries depends on narrowing the large gap in labour productivity and

Table 1.2. **Financial status of households by income quintile**

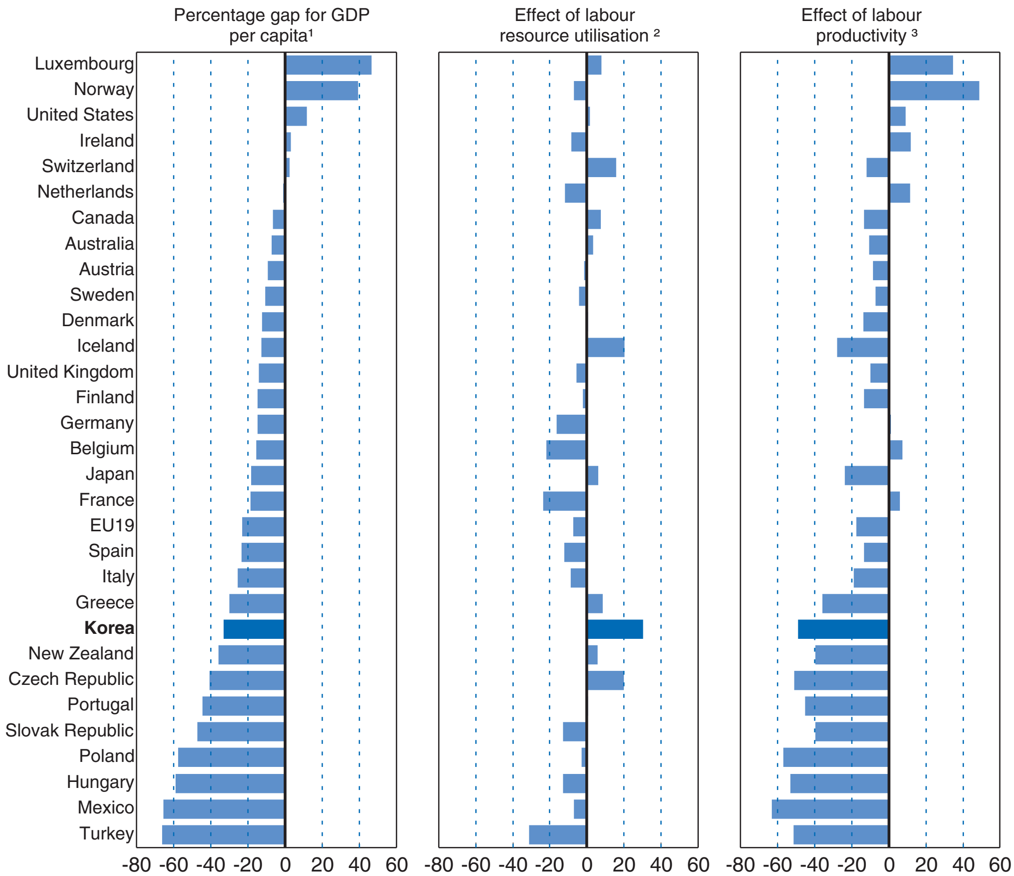
In per cent

	Lowest quintile I	Second quintile II	Third quintile III	Fourth quintile IV	Highest quintile V	Total
Share of indebted households	24	40	48	53	53	44
Proportion of total debt	5	10	16	23	46	100
Proportion of total assets	3	7	13	24	52	100
Total debt/financial assets	12.4	11.0	6.1	4.2	2.8	3.8
Debt-service ratio	28	14	12	11	11	..

Source: Kim *et al.* (2009).

Figure 1.4. **Explaining differences in income**

In 2008



1. Relative to the simple average of the highest 15 OECD countries in terms of GDP per capita, based on 2008 purchasing power parities (PPPs). The percentage gap in labour resource utilisation and labour productivity do not add up exactly to the GDP per capita gap since the decomposition is multiplicative.
2. Labour resource utilisation is measured as total number of hours worked per capita.
3. Labour productivity is measured as GDP per hour worked.

Source: OECD (2010a), *Going for Growth*, OECD, Paris.

StatLink http://dx.doi.org/10.1787/888932302397

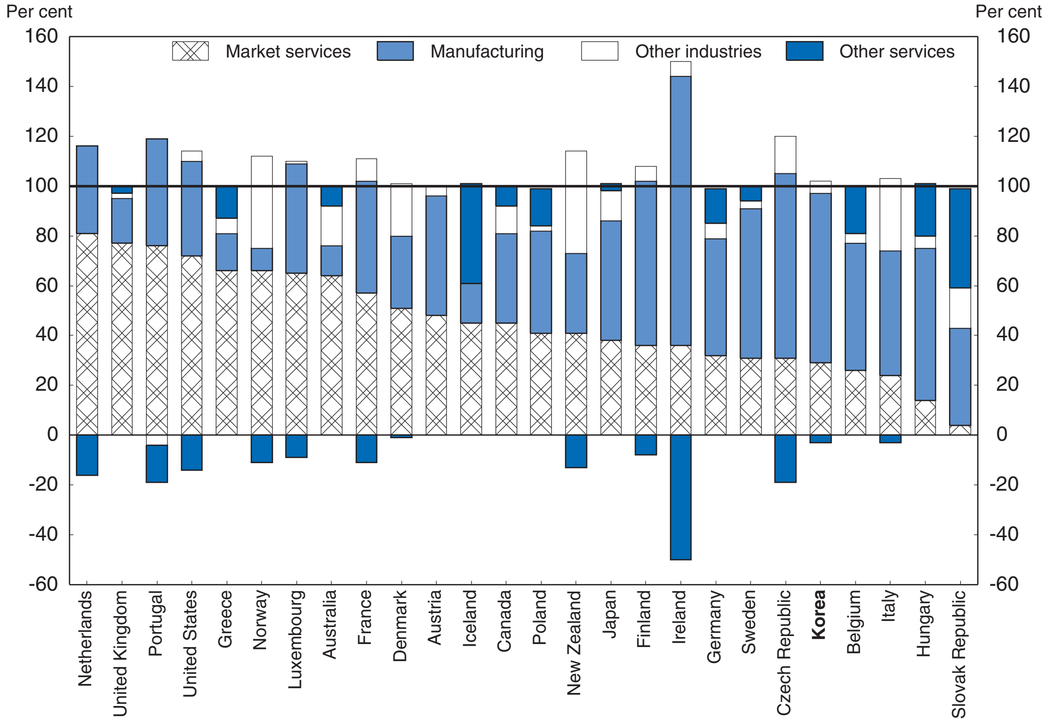
mitigating the fall in labour inputs. This section first discusses policies to boost labour productivity in Korea's non-manufacturing sector, notably services, and then focuses on measures to promote labour force participation, particularly for women and older persons.

Raising productivity in the non-manufacturing sector

Korea's service sector is relatively small, accounting for 60% and 67% of value added and employment in 2008, respectively, the second-lowest shares in the OECD area. The Korean economy has been led by manufacturing: only four of the 30 largest enterprises are in services, compared to 12 in the United States. The contribution of market services to aggregate productivity growth in Korea from 2000 to 2008 was one of the smallest in the OECD area and was partially offset by a fall in other services (Figure 1.5). Consequently, the level of productivity in services in Korea is relatively low at 58% of the manufacturing sector and 44% of the US service sector (MOSF, 2009).

Figure 1.5. **Share of the service sector in productivity growth**

Between 2000 and 2008



Source: OECD DSTI Database.

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The government recognises that "Overly strict regulations are also obstructing investment and competition" in services (MOSF, 2009). It is also concerned by the trade deficit in services, which increased from 0.7% of GDP in 2000 to 2.1% in 2009, but this reflects Korea's strong comparative advantage in manufacturing and should not be a problem. Korea's current account has averaged a surplus of 1.8% of GDP since 2000, and is even higher now, implying that there is no need to improve its external balance. The key objective ought to be generating employment and boosting domestic demand by promoting the development of services. Experience shows that market opening allows new firms, such as low-cost airlines, to offer new services, thereby opening up new areas of consumer demand. Stronger domestic demand would also reduce Korea's heavy reliance on exports and its vulnerability to foreign shocks, while providing beneficial spillovers to other countries. At the same time, more efficient service industries would also benefit other sectors, notably manufacturing, that use service-sector inputs. In other words, ensuring a competitive and dynamic service sector would have a double impact.

The government launched a major initiative in May 2009 to develop services. One objective is to provide a more level playing field between services and manufacturing, which receives greater tax incentives, fiscal aid and SME support. For example, knowledge-based services are being given more government credit guarantees. To increase the amount of SME assistance received in the service sector, the government greatly relaxed the requirements for service firms to be classified as SMEs.[12] However, providing more equal treatment between services and manufacturing would be better achieved by scaling back benefits to manufacturers, thereby reducing the fiscal cost, as well as the distortions that are likely to occur from fiscal support and tax expenditures.

In addition, in January 2009, the government identified five service sectors, including heath care, education, green financing (Chapter 5), contents and software, and conventions and tourism (Table 1.3). The government has developed a strategy to develop each of these services (National Council for Science and Technology, 2009). The May 2009 initiative also selected nine services with the aim of creating high-quality jobs and supporting economic growth. Five areas – medical services, logistics, consulting, design and IT services – were chosen because of their high value-added and strong growth potential. Another four – education, content provision, broadcasting and communications, and employment support – were designated because of their prospects for creating more jobs and reducing the trade deficit in services (MOSF, 2009).

Table 1.3. **New growth industries announced in January 2009**

Sector	New growth engines
Green technology industry	● New renewable energy ● Low carbon energy ● Water technology ● LED application ● Green transport system ● High-tech green city
State-of-the-art fusion industry	● Media communication fusion ● IT fusion system ● Robot application ● New materials and nano-fusion ● Biomedicine and medical devises ● High value-added food industry
High value-added service industry	● Global health care ● Global education services ● Green financing ● Contents and software ● Conventions and tourism industry

Source: National Council for Science and Technology (2009).

More important and less risky than service industry-specific measures are broader policies to strengthen competition in services by eliminating domestic entry barriers, accelerating regulatory reform, upgrading competition policy and reducing barriers to trade and inflows of foreign direct investment (FDI), as recommended in the 2008 *OECD Economic Survey of Korea* (Box 1.1). The government has had success in reducing entry barriers, as reflected in the improvement in Korea's ranking in the category "cost of starting a new business" from 126th in the world to 53rd for the year to May 2009, according to a World Bank study (Table 1.4). The progress reflects the easing of the minimum capital provision and a reduction in the number, time required and cost of procedures to start a new business, although each indicator is still above the OECD average. The Korea Fair Trade Commission (KFTC) has also taken steps to remove measures that restrict entry and reduce consumer welfare. *First,* it identified 68 anti-competitive regulations imposed by lower-level governments and received pledges to improve almost half of them. *Second,* the KFTC analysed 60 market entry regulations that distort the market structure and reached agreements with the relevant government agencies to improve 26 of them. While the KFTC has had some success, half of the anti-competitive measures that it identified have not been changed, suggesting that industry promotion efforts take precedence over competition in many areas.

Box 1.1. **Taking stock of structural reforms: enhancing productivity growth in the service sector**

Recommendations in the 2008 *Survey*	Actions taken or proposed by the authorities
Provide a favourable environment for the service sector	
Scale back government assistance to SMEs, including subsidies, financial aid, credit guarantees and tax incentives, to make them less dependent on such support.	Government assistance to SMEs was significantly increased in 2009 through higher subsidies, expanded credit guarantees and measures to boost bank lending to SMEs.
Eliminate discrimination against the service sector by ensuring equal treatment with manufacturing.	The definition of SMEs in the service sector was relaxed to allow more firms to receive tax benefits and financial support.
Establish an efficient reporting system for intellectual and intangible assets and provide adequate protection of intellectual property to encourage investment in intangible assets.	Legislation to deal with copyright infringement on the Internet was introduced in July 2009, while measures to deal with counterfeit goods have been upgraded.
Accelerate regulatory reform	
Enhance the use of regulatory impact assessments (RIAs) and public consultations to improve the quality of regulation and adopt an explicit policy that regulations can only be adopted if the benefits justify the costs.	Guidelines for RIAs were introduced in December 2008.
Step up the pace of regulatory reform to reduce entry barriers and regulations that limit competition and expand the scope to cover additional areas, such as industrial and regional policies.	The Korea Fair Trade Commission identified 60 market entry regulations and reached an agreement with relevant government ministries to improve 26 of them. The time and cost of starting a new business was significantly reduced.
Create a mechanism in the National Assembly to ensure the regulatory quality of proposed legislation.	No action taken.
Extend successful reforms introduced in special zones on a nation-wide basis and phase out the special zone approach.	No action taken.
Upgrade the competition framework	
Strengthen the deterrent effect of surcharges and criminal penalties, including individual sanctions.	The number of criminal penalty cases increased from 33 in 2008 to 43 in 2009 while the amount of surcharges rose by 36%.
Provide the KFTC with compulsory investigative powers for more effective enforcement.	No action taken.
Scale back remaining exemptions from the competition law and preferential measures, particularly for SMEs.	No action taken.
Strengthen international competition	
Promote inward FDI by eliminating restrictions on foreign ownership and improving the business climate.	In July 2009, foreign investors were allowed to own up to 20% of firms that provide content for Internet multimedia broadcasting.
Liberalise product market regulations, which tend to discourage potential foreign investors.	In 2009, 175 regulations restricting location, facilities, etc. in new growth engine sectors were relaxed or removed.
Utilise FTAs to strengthen competition in the service sector and reduce barriers that limit trade.	The Korea-EU FTA was initialled in October 2009.The Korea-India Comprehensive Economic Partnership Agreement, which includes services, came into effect in 2010.
Remove restrictions and enhance competition in key service industries	
Telecommunications	
Safeguard in practice the independence and transparency of the KCC's regulatory decisions, as spelled out in the law.	No action taken.
Relax foreign investment restrictions.	No action taken.
Further liberalise entry requirements for facility-based services.	No action taken.
Introduce an auction system for the allocation of spectrum, while promoting a secondary market.	A January 2009 bill to allow operators to choose between the existing fee-based system and an auction system is pending.
Liberalise regulations on CATV to create a level playing field with the converged services of IPTV.	Limits on the market share of CATV and on the number of CATV stations owned by one operator were eased in late 2008.
Business services	
Remove unnecessary constraints on entry, form of practice, advertising, and foreign participation, in line with the OECD guidelines for the regulation of business services.	No action taken.
Encourage international competition by expanding recognition of certificates acquired overseas.	The US-Korea FTA will allow US attorneys to provide counsel on US and international law.
Raise and eventually abolish the ceiling on the number of law students and persons passing the bar exam.	The number of new entrants into the legal profession was cut from 2 000 to 1 000 in 2010 but is to be raised to 2 300 in 2012.

Table 1.4. **Time and cost of starting a new business**

Countries shown by their rank from least to most restrictive

	2009 world ranking	2008 world ranking	Number of procedures	Time (days)	Cost (per cent of income per capita)	Minimum capital (per cent of income per capita)
New Zealand	1	1	1	1	0.4	0.0
Canada	2	2	1	5	0.4	0.0
Australia	3	3	2	2	0.8	0.0
United States	8	6	6	6	0.7	0.0
Ireland	9	5	4	13	0.3	0.0
United Kingdom	16	8	6	13	0.7	0.0
France	22	14	5	7	0.9	0.0
Denmark	28	16	4	6	0.0	38.6
Finland	30	18	3	14	0.9	7.2
Belgium	31	20	3	4	5.3	19.4
Iceland	33	17	5	5	3.0	15.8
Norway	35	33	5	7	1.9	18.7
Hungary	39	27	4	4	8.0	10.2
Sweden	43	30	3	15	0.6	28.5
Korea	**53**	**126**	**8**	**14**	**14.7**	**0.0**
Turkey	56	43	6	6	14.2	9.5
Portugal	60	34	6	6	6.4	33.5
Slovak Republic	66	48	6	16	2.0	23.8
Chile	69	55	9	27	6.9	0.0
Netherlands	70	51	6	10	5.6	49.4
Switzerland	71	52	6	20	2.0	26.4
Luxembourg	72	69	6	24	1.8	19.9
Italy	75	53	6	10	17.9	9.7
Germany	84	102	9	18	4.7	0.0
Mexico	90	115	8	13	11.7	8.9
Japan	91	64	8	23	7.5	0.0
Czech Republic	113	86	8	15	9.2	30.5
Poland	117	145	6	32	17.9	15.3
Austria	122	104	8	28	5.1	52.0
Greece	140	133	15	19	10.9	21.4
Spain	146	140	10	47	15.0	12.8
Average			**5.9**	**13.9**	**5.7**	**14.6**

Source: World Bank (2009), *Doing Business 2010*.

Strengthening links to the world economy is another means to boost productivity growth in services. The globalisation of services has been driven by technological advances, such as broadband networks and digitalisation, regulatory reform and trade liberalisation. Despite increasing openness, Korea's level of integration with the world economy is still very low in terms of import penetration, the share of foreign workers and the stock of inward FDI (2007 *OECD Economic Survey of Korea*). Korea has taken steps to increase international competition in services through its growing participation in free trade agreements (FTAs) since 2004:

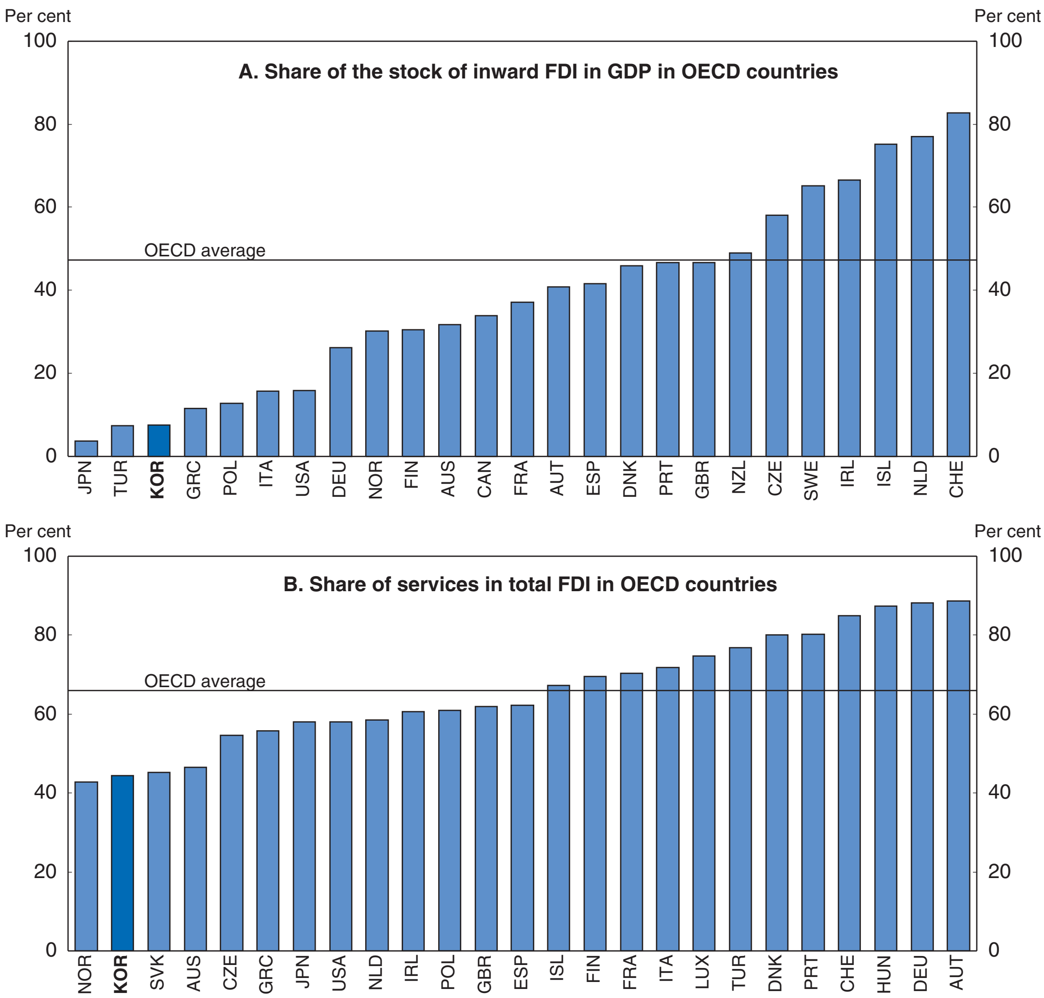
- Korea has five agreements in effect covering about 15% of its international trade: Chile (2004), Singapore (2006), EFTA (2006) and ASEAN (2006 and later expanded to include services in 2009). In addition, a Comprehensive Economic Partnership Agreement (CEPA) with India (2010) covers professionals in 163 categories, including computer experts and management technology.

- Korea has signed or initialled agreements with the United States (2007) and the EU (2009) that are still awaiting final approval. These FTAs will include significant liberalisation in professional services, such as law and accounting, and in transport, distribution, construction and finance.
- Korea is currently negotiating agreements with Australia, Canada, Columbia, Japan, Mexico, New Zealand and the Gulf Co-operation Council.
- FTAs are under joint study or consideration with China, Israel, Turkey, the Russian Federation, Mercosur and the South Africa Customs Union.

Efforts to liberalise trade through FTAs may also help boost the stock of inward FDI from its 2008 level of 8% of GDP, the third lowest in the OECD area (Figure 1.6). Moreover, Korea is one of only four countries where the share of FDI in services is less than one-half of the total stock. Consequently, the stock of inward FDI in services is only 4% of GDP in Korea compared with an OECD average of 28%. FDI inflows increased by 11.4% in 2008,

Figure 1.6. **International comparison of the stock of inward foreign direct investment**

In 2008 or latest year available



Source: *OECD Economic Globalisation Indicators Database.*

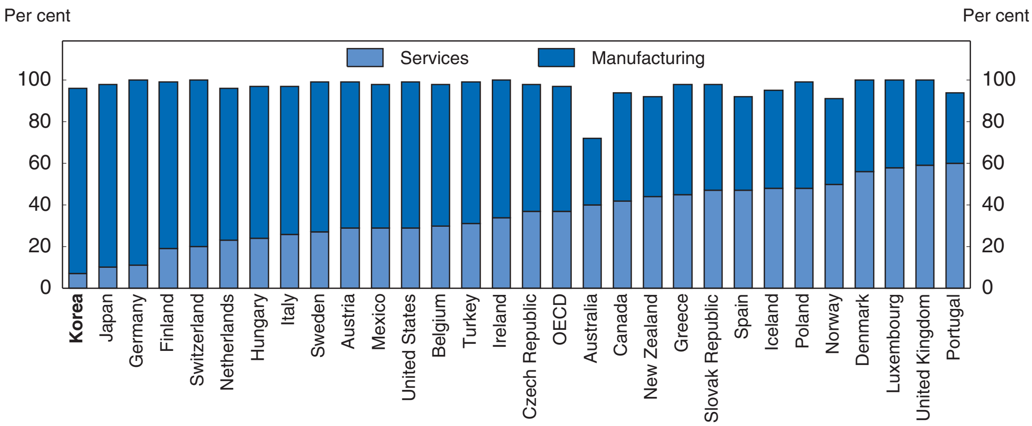
StatLink http://dx.doi.org/10.1787/888932302435

reversing a prolonged downward trend, and declined by less than 2% in 2009 despite the sharp contraction in the global economy. To encourage inflows, Korea should further relax FDI restrictions, including foreign ownership ceilings in key services, and liberalise product market regulations.[13] In addition, it is important to foster a foreign investment-friendly environment, thereby encouraging more cross-border M&As, enhance the transparency of tax and regulatory policies and reform the labour market (see below). The treatment of manufacturing and services in the six Free Economic Zones should be more balanced. While all manufacturing industries qualify for benefits, including tax breaks and rent support, logistics, tourism, education, R&D and medical services are the only eligible service sectors. Finally, the emphasis on special zones should not distract policymakers from the top priority of improving the business climate.

Greater competition in services – both domestic and foreign – would also help encourage innovation. Korea is a front-runner in R&D, an important element of innovation, spending 3.2% of GDP in 2007, the fourth highest in the OECD. However, the service sector accounts for only 7% of private-sector R&D, the lowest share in the OECD area and far below the average of 35% (Figure 1.7). In addition to strengthening competition, the government's policies for promoting innovation should be oriented more toward service firms, while raising the service sector's awareness of existing public programmes. In addition, links between service firms and government research institutions should be strengthened. In sum, Korea's exceptional economic development over the past half century has been driven in no small part by its successful innovation in manufacturing. The priority now is to extend rapid innovation to other parts of the economy, notably services.

Figure 1.7. **R&D spending in the manufacturing and service sectors**

Business enterprise expenditure on R&D by sector in 2007 or latest year



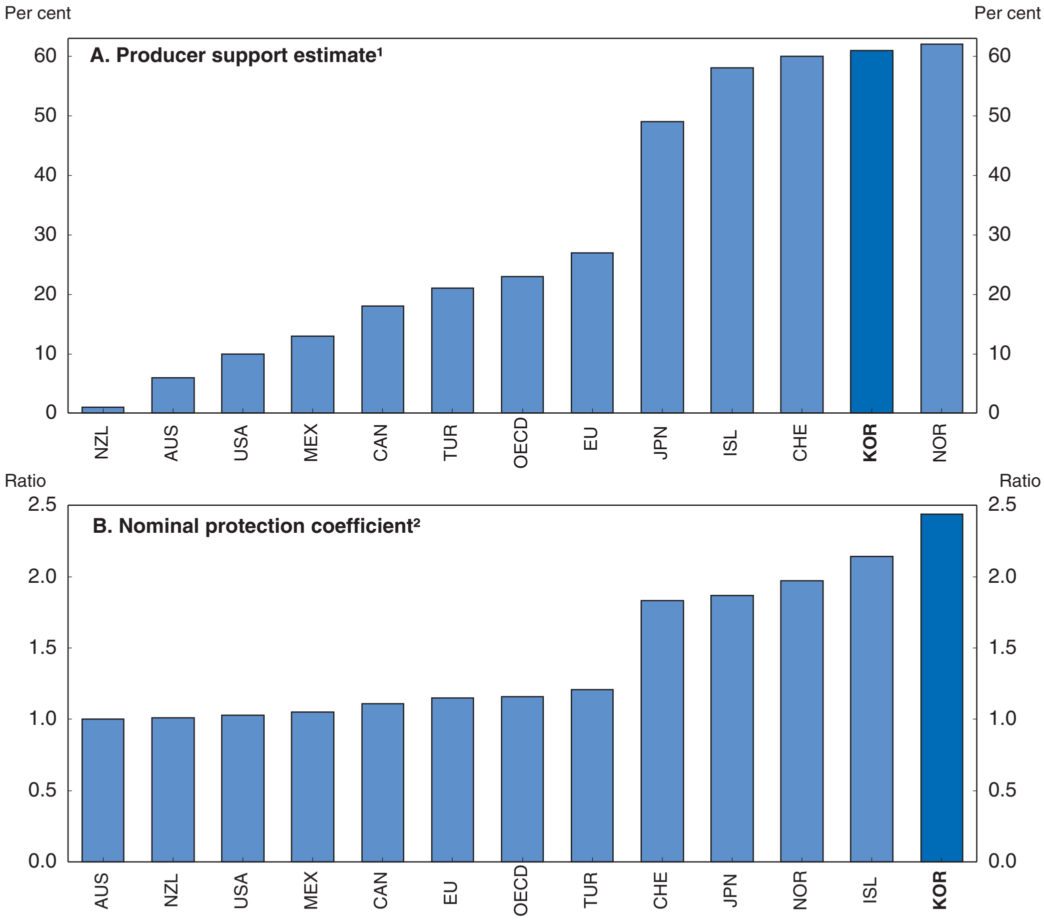
Source: *OECD DSTI Database.*

StatLink http://dx.doi.org/10.1787/888932302454

Agriculture, another low-productivity sector in Korea, receives a high level of support that imposes heavy burdens on consumers. Although agricultural support, as measured by the percentage producer support estimate (PSE), has fallen from 70% of the value of agricultural production in 1986-88 to 61% in 2006-08, it remains far above the OECD average of 23% (Figure 1.8). Total support to agriculture amounted to 2.9% of GDP over that period and made consumers pay more than double the world price for agricultural products

Figure 1.8. **International comparison of agricultural support**

Average of 2006-08



1. The PSE is an indicator of the value of monetary transfers to agriculture resulting from agricultural policies. It is presented as a share of the total value of production at domestic producer prices.
2. The nominal protection coefficient is a measure of market protection defined as the ratio between the average prices paid by consumers and the international price.

Source: OECD (2009a), *Agricultural Policies in OECD Countries 2009: Monitoring and Evaluation*, Paris, OECD.

StatLink http://dx.doi.org/10.1787/888932302473

(Panel B). Market price supports, which distort production and trade, accounted for 87% of the support provided in Korea in 2008, compared to 47% in the OECD area. It is essential to replace them with direct support for farmers, thus limiting the distortions to production and trade. While FTAs are helping to open the market, agricultural products receive special treatment. For example, Korea's FTA with ASEAN excludes rice and gives special treatment to other major agricultural goods as "hyper-sensitive products". The government is trying to strengthen the links between agriculture and the food industry through reforms to increase the competitiveness of agricultural firms and farmer organisations. However, more measures are needed to attract the participation of non-agricultural corporations and facilitate the emergence of new types of business organisations (OECD, 2009a).

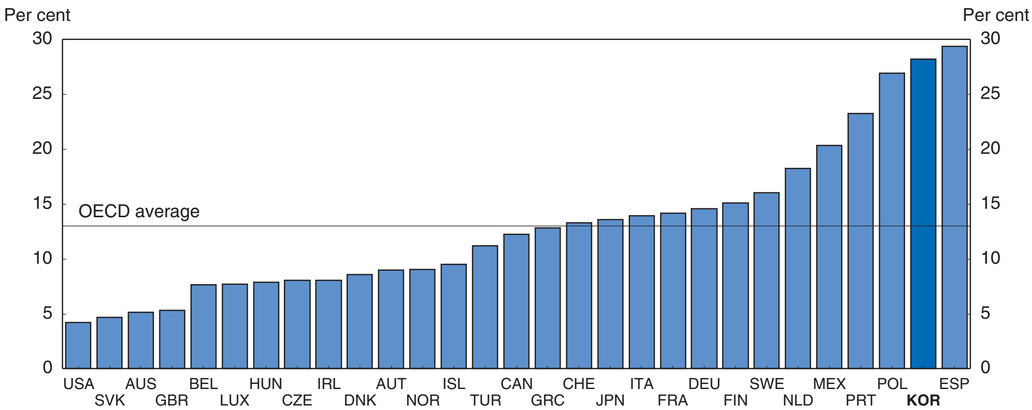
Labour market reform

Reducing the large share of non-regular workers

A major problem in the labour market is the rising degree of dualism: the share of "non-regular workers" now exceeds one-third of employees. The concept of non-regular employment includes workers with fixed-term contracts, part-time workers (those working fewer hours than full-time workers) and atypical workers (temporary agency workers, home-based workers, etc.). The largest component of non-regular employment is temporary workers, whose share of employment increased from 16.6% in 2001 to 28% in 2007, the second highest in the OECD area (Figure 1.9). According to surveys, firms hire non-regular workers to reduce labour costs and to increase employment flexibility, given the difficulty of laying off regular workers (OECD, 2007). According to one study, the productivity of non-regular workers is 22% below that of regular workers, while their wages are 44% less (Korea Employers Federation, 2006). In addition, firms face lower social charges for non-regular workers due to gaps in social insurance coverage: the share of non-regular workers participating as employees in 2009 was 38.2% for the National Pension Scheme, 42.7% for the Employment Insurance Scheme and 43.4% for National Health Insurance.

Figure 1.9. **International comparison of temporary employment**

As per cent of total employment in 2008[1]



1. Reference year is 2001 in Greece, 2004 in Mexico, 2005 in the United States, 2006 in Australia and 2007 in Korea.

Source: OECD Employment Outlook Database.

StatLink http://dx.doi.org/10.1787/888932302492

The high proportion of temporary workers is a drag on growth as it increases worker turnover and hence reduces firm-provided training, which plays a very important role in Korea. It also raises equity issues as non-regular workers face precarious jobs, wage discrimination and less social protection. Reducing dualism requires weakening the incentives that encourage firms to hire non-regular workers. One priority is to liberalise employment protection for regular workers so that firms can achieve their desired flexibility without depending as much on non-regular workers (Box 1.2). A second priority is to increase the coverage of non-regular workers by the social safety net, thus improving equity and narrowing the gap in labour costs. Finally, it is important to increase training opportunities for non-regular workers to enhance their employment prospects. Public spending in Korea on labour training programmes as a share of GDP is one of the lowest in the OECD.

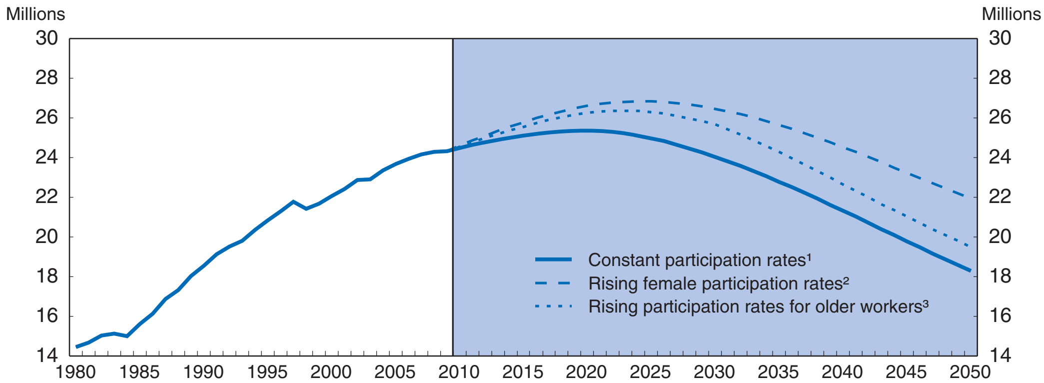
Box 1.2. **Taking stock of structural reforms: the labour market**

Recommendations in the 2008 *Survey*	Actions taken or proposed by the authorities
Reverse the trend toward increasing labour market dualism	
Liberalise employment protection for regular workers to reduce the incentive for hiring non-regular workers to enhance employment flexibility.	No action taken. The Economic and Social Development Commission, created in June 2009, is discussing ways to improve labour-related institutions and practices.
Expand the coverage of social insurance schemes to reduce firms' incentives to hire non-regular workers and provide better protection for such workers.	The collection of social insurance contributions for pensions, health, long-term care, employment and industrial accidents was combined in one agency, which may help improve the coverage for non-regular workers and small firms.
Ensure that the newly implemented law to protect non-regular workers does not slow employment growth.	Occupations facing large-scale layoffs can be exempted from the limit of two years for fixed-term workers.
Raise the labour force participation rate of women, while encouraging higher fertility	
Expand the availability of high-quality childcare by relaxing price controls on private-sector providers.	No action taken.
Lengthen maternity leave and ensure that eligible persons are able to take maternity and parental leave, while promoting family-friendly workplaces.	Parental leave was expanded for those with children age three and younger to those with children too young for primary school.
Reduce the use of seniority-based wages and reverse labour market dualism to provide better job opportunities for women.	The system of paying allowances to older workers whose wages decline under peak-wage systems was made permanent in 2009. A public research institute is providing consulting to support wider use of performance-based wages.
Improve job prospects for youth	
Reduce mismatches between skills provided in tertiary education and those required in the labour market by strengthening links between universities and companies.	Agreements for joint training by companies and Polytecs have been implemented and special training programmes for university graduates have been established in Polytecs.
Improve the quality of tertiary education by strengthening competition through increased transparency about performance, stronger accreditation procedures and regulatory reform.	The government introduced a university information disclosure system which requires universities to disclose major outcomes since end-2008. A university evaluation and accreditation system is being implemented in 2010.
Expand public support for universities as the number of elementary and secondary students decline.	The government is increasing spending in this area by 22% between 2008 and 2010.
Reduce the number of those who are not in employment, education or training (NEETs) by reversing the upward trend in non-regular employment.	The Youth New Start Project was launched, with outlays of 17 billion won in 2009, to integrate young adults lacking education and job experience into the labour force.
Improve quality and efficiency of public education to curb demand for after-school tutoring, in part by bringing teachers' salaries more in line with average income.	The government has launched a number of initiatives, including the "school autonomy expansion plan" in 2009, a teacher evaluation system in 2010 and the designation of high-quality schools where students do not need after-school tutoring.
Follow through on the plan to allow more independent schools to promote both efficiency and quality.	The government introduced an "autonomous private" high school system in 2009, with 25 such schools.
Promote the employment of older workers	
Abolish the mandatory retirement system, thus helping to flatten the wage-seniority profile.	The government provided financial aid for consultation costs for 33 companies introducing the Wage Peak System in 2009.
Phase out the retirement allowance by accelerating the introduction of company pensions.	A bill to simplify the introduction of company pensions is pending in the National Assembly that would, for example, make company pensions the default for newly established companies.
Improve ALMPs by focusing on training rather than wage subsidies and direct job creation.	A programme to help the older unemployed find jobs trained 700 persons in 2009 and is expected to train 3 000 in 2010.

Raising women's labour force participation rate

Population ageing is another challenge for Korea. Indeed, the rise in the elderly dependency ratio by 2050 is projected to be the largest in the OECD area, according to the government's population projections (Figure 4.8). If participation rates were to remain at their current levels for each age group, the labour force would peak at 25.4 million in 2020 and then fall by more than a quarter to around 18 million by mid-century (Figure 1.10). By

Figure 1.10. **Long-term projections of the labour force**



1. The participation rates for men and women are assumed to remain at their current levels for each age group.
2. Female participation rates are assumed to reach current male rates in each age group by 2050.
3. The participation rates are assumed to converge by 2030 to the maximum value in the OECD for each gender and age group over 50, while the rates for younger workers remain at their current levels.

Source: OECD Secretariat calculations based on population projections by the Korea National Statistical Office.

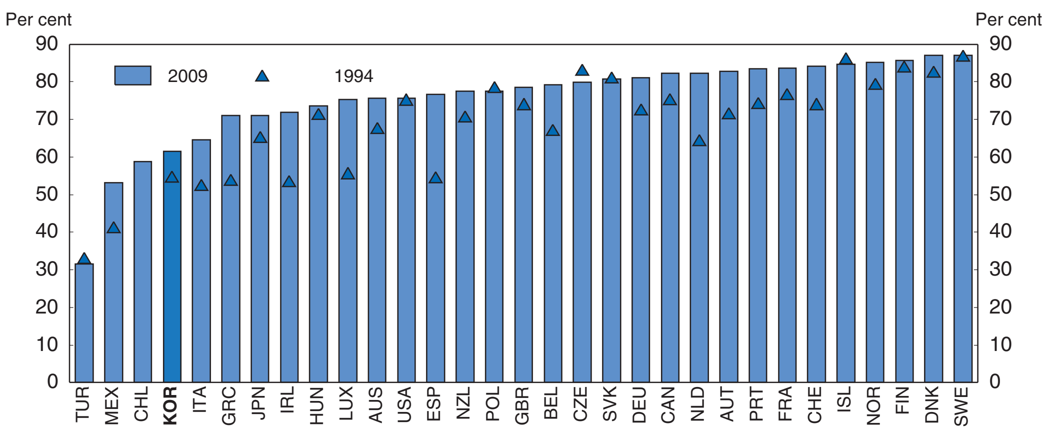
StatLink http://dx.doi.org/10.1787/888932302511

that point, there would be only 1.1 persons in the labour force for every elderly person, compared with 4.7 in 2009, suggesting that financing social spending would impose a heavy burden on workers. One option to ease the demographic burden would be immigration, although inflows have been closely restricted thus far. Indeed, foreign workers accounted for only about 1% of the labour force in Korea, well below the OECD average of 10% (OECD, 2007).

The most important strategy would be to increase women's participation rate, which is relatively low. For women between the ages of 25 and 54, the rate was 62% in 2009, the fourth lowest in the OECD area and far below the rates of over 80% in some OECD countries (Figure 1.11). If the female participation rate in Korea were to converge to the current level for males for each age group by 2050, the fall in the labour force would be limited to around 22 million, almost 20% higher than in the case of an unchanged participation rate

Figure 1.11. **International comparison of female labour force participation rates**

Rates for women aged 25 to 54 in 2009



Source: OECD (2010d), *OECD Employment Outlook 2010*, OECD, Paris.

StatLink http://dx.doi.org/10.1787/888932302530

(Figure 1.10). The lower participation rate for women in Korea reflects a number of factors. *First,* the gender wage gap in Korea is one of the highest in the OECD area, owing to the large share of women in non-regular employment, the tradition of seniority-based wages and the low share of women in managerial jobs. *Second,* there is a lack of suitable childcare. In a government survey (Ministry of Labour, 2008), more than 60% of women responded that the "burden of childcare" was the primary obstacle to joining the labour force. *Third,* the limited length (90 days) and coverage of maternity leave constrains female employment. *Fourth,* long working hours in Korea make it difficult to combine paid employment with family responsibilities, thus discouraging female employment. Despite the gradual introduction of the 40-hour work week from 2004, annual working hours are still more than one-third higher than the OECD average.

Addressing these issues is key to boosting female labour force participation and mitigating the impact of population ageing. *First,* reducing the gender gap requires tackling the non-regular worker problem and encouraging a move towards performance-based pay. *Second,* the availability and quality of child-care needs to be expanded, while making it more affordable, in part by relaxing price controls on private-sector suppliers (Box 1.2). *Third,* maternity leave should be lengthened beyond 90 days, while encouraging greater use of parental leave. While these policies are important, their impact would be limited in workplaces that are not family-friendly, not least due to very long working hours. Family-friendly workplaces are essential for the reconciliation of work and family life and also have important implications for the very low fertility rate of 1.2 in 2008. In short, the labour market will have to adjust in order to provide mothers with the hours, jobs, wages and careers that will attract them back into employment.

Making better use of older workers

Another key to mitigating the impact of population ageing is to increase the employment of older workers. Labour force participation in Korea remains above the OECD average for men over 50 and for women over 60. Nevertheless, the labour force would be 7% larger in 2050 if the participation rate for each gender and age group over 50 rose to the highest rate in the OECD, while the rates for younger workers remain at their current levels.

Equally important is to effectively utilise older workers. While older persons are likely to remain in the labour force, they tend to retire from their main career by age 55. Indeed, the average employment tenure peaks in the 45-to-49-age group – well below most other OECD countries where the peak is in the 55-to-64-age group – and then falls sharply. About three-quarters of departing employees become self-employed, primarily in services with low productivity. As a result, a third of workers over age 50 are self-employed, compared to 13% of those under that age. As for workers still employed past 50, more than two-thirds in 2007 worked in firms with less than 100 workers and a majority were non-regular workers.

The importance of seniority in determining wage levels is a major reason for the early departure of employees. For example, a worker with 25 years of tenure in a company is paid almost three and a half times more than a newly-hired employee despite having less education on average. Companies in which wages are closely linked to seniority hire fewer older workers (Lee, 2008). In 2005, 85% of firms with more than 300 workers set mandatory retirement below the age of 60 recommended by law. Mandatory retirement enables firms to dismiss older workers as their seniority-based wages surpass their productivity and, given the difficulty of dismissing regular employees, helps firms adjust their workforces to the business cycle.

A second factor promoting the early departure of older workers from enterprises is the retirement allowance. By law, firms must pay a lump sum of at least one month of wages to each departing employee for each year worked, although many pay about twice that amount in practice. Given that the lump sum is based on the employee's final wage, which rises sharply with seniority, it creates a disincentive to keep older employees. The allowance is not a secure source of income, as it is only partially funded, making payments dependent on the firm's survival. Moreover, this payment has lost its link to retirement income as most workers receive such lump sums a number of times during their working life.

In addition, many older workers lack the skills necessary in Korea's increasingly knowledge-based economy. The share of the 55-to-64-age cohort with a tertiary education was only 11% in 2007, compared to 56% for the 25-to-34-age cohort, the highest in the OECD. The education gap between older and younger age cohorts is thus the largest in the OECD, leaving older workers at a disadvantage. Indeed, about two-thirds of workers over 50 are in physically-demanding jobs, such as manual work, which tend to be low-paid.

The government's "Basic Plan to Promote Employment of the Aged", which runs through 2021, aims at increasing the employment rate of the 55-to-64-age group from 59% in 2005 to at least 63% (OECD, 2008) through a number of policy initiatives. *First,* the government is encouraging firms to raise their mandatory retirement age, with a goal of eventually eliminating it altogether.[14] *Second,* government programmes are supporting the re-employment of older persons who left firms involuntarily because of the mandatory retirement age or dismissal. *Third,* the government is introducing new wage subsidies. For example, the government subsidises firms for up to five years if they guarantee employment to workers until their retirement age, extend their retirement age or offer re-employment programmes to retirees.

Instead of wage subsidies to reduce the cost of older workers relative to younger ones, it is important to achieve wage flexibility so that older workers remain affordable. Such flexibility would allow more opportunity for "continuous employment" at the same firm, which is more attractive than self-employment or non-regular work, thus encouraging older workers to remain in the labour force. One priority is to require companies to set mandatory retirement at an age closer to the pension eligibility age – or forbidding the use of mandatory retirement altogether – thereby helping to change the seniority-based wage system. Firms agree to steep seniority-based wage profiles on the condition that they can force older workers to leave. Without mandatory retirement, firms would insist on wage systems that more closely reflect productivity.

In addition, the retirement allowance system should be abolished in order to reduce firms' incentives to retire older workers, as well as to enhance labour mobility. The company pension system introduced in 2005 in workplaces with at least five employees would provide better income security for retired workers. This requires labour and management to agree on a defined-benefit (DB) or a defined-contribution (DC) scheme. However, progress in introducing company pensions has been hindered by the disagreement between employers and employees as to which type of plan to introduce. Workers tend to favour DB plans, which are similar to the current retirement allowance in guaranteeing the benefit paid, while employers tend to favour DC plans. The introduction of a company pension while maintaining the retirement allowance reflects the difficulty of phasing out the latter, which is popular with workers. To accelerate the transition to company pensions, the government should end the preferential tax treatment for retirement allowances, which allows the lump sum to be taxed over a number of years at low rates, a more favourable arrangement than that granted to company pension systems. Moreover, the government should encourage DC plans in order to promote pension portability and thereby labour mobility.

Finally, greater emphasis on lifelong learning and training would likely improve the job prospects for older workers more than employment subsidy programmes. Government expenditures on lifelong learning, including vocational training, amounted to only 0.1% of GDP in 2007 and less than one-third of adults participate in lifelong education. The rate rises with the level of education, making it important to focus more on less-educated persons. In addition, training has to be carefully targeted on the needs of enterprises to be effective. Such training could be financed by reducing wage subsidies, which tend to delay structural change and to distort the composition of the labour force by changing the relative cost of older workers relative to younger ones.

Policies to promote growth and sustainability

Korea's strong recovery from the global financial crisis is expected to continue, as explained above, raising the question of the appropriate timing and speed of the exit from exceptional fiscal and monetary policy, which is discussed in Chapter 2. Given rapid population ageing and the potential cost of closer economic integration with North Korea, maintaining a sound fiscal position is a priority in Korea. Moreover, falling behind the curve on withdrawing monetary stimulus raises the risk of higher inflation that would necessitate a substantial tightening of the monetary policy stance, which could undermine the expansion.

Korea's financial sector, examined in Chapter 3, appears to be in relatively sound shape following the global financial crisis. However, there is also the question of an exit strategy from the exceptional support provided to financial institutions to help them cope with the crisis, and from the measures to encourage lending to SMEs. Korea faces the longer-term issue of how to reduce its vulnerability to external shocks. In addition, there are a number of other policy challenges, such as containing the risks of mortgage lending while not stifling residential investment, the appropriate role of securitisation and improving corporate governance. The government's reform plans, aimed at reducing segmentation, also raise questions as the post-crisis financial framework evolves.

Rising public spending on health and long-term care is one of the fiscal challenges facing Korea. While it is still low compared to other OECD countries, as explained in Chapter 4, rapid population ageing and expansion of the relatively limited National Health Insurance will put significant upward pressure on spending in coming years. There are important issues of how to increase efficiency to limit the rise in spending and how to best finance such expenditures. The heavy reliance on patients' out-of-pocket payments raises issues of adequate access to health care for low-income persons and those with chronic illness. In addition, while there is dissatisfaction with the quality of health care, there is reluctance to boost spending, given fears that it will simply increase the income of health suppliers without raising quality.

Korea has proclaimed "Low Carbon/Green Growth" as the nation's vision to guide development during the next 50 years and launched a five-year programme costing 10% of GDP to promote it, as discussed in Chapter 5. The ambitious plans raise questions of how the government can promote the growth of new industries without creating distortions in resource allocation and wasteful spending. Green growth includes the objective of climate change mitigation and Korea's commitment to cut its greenhouse gas emissions by 30%, relative to a business-as-usual baseline, by 2020. Given the ambition of these goals, measures to achieve them in a cost-effective manner are essential.

Notes

1. The size of a country's decline in exports between the third quarter of 2008 and the first quarter of 2009 was linked to its concentration in medium and high-technology products (OECD, 2009b).
2. Korea recorded an 8% rise in its export performance in 2009 (defined as export volume growth divided by the weighted average of import growth in Korea's export markets), well above the OECD average of 3% in 2009 and Korea's 2.3% annual average increase between 2002 and 2008.
3. One advantage of comparing changes since the fourth quarter of 2008 is that it was the quarter with the sharpest output decline for the OECD area as a whole, as well as for most of the OECD member countries.
4. The won depreciated by 35% relative to the Chinese renminbi between the first quarters of 2008 and 2009.
5. However, the increase in output by the fourth quarter of 2009 relative to the pre-crisis peak was higher in Poland (2.6%) and Australia (1.9%) than in Korea (1.2%).
6. In 2009, an estimated 801 thousand persons participated in these public employment programmes, which lasted between three and 12 months, with the annual average at 504 thousand.
7. The government assumes that 40% of the additional public jobs crowded out private-sector employment creation, thus reducing the net additional employment effect to 165 thousand (60% of the 276 thousand rise in public employment in 2009).
8. These comparisons are based on exchange rates of 10 May 2010, the rates used in the projections.
9. At 100, the number of consumers who are optimistic about the future matches the number who are pessimistic.
10. The contribution from stockbuilding is projected at zero in each of the remaining quarters of 2010 and in 2011, although the carry-over from 2009 makes a positive contribution of 2.2 percentage points to growth in 2010.
11. The self-employed account for one-third of total employment in Korea, the fourth highest in the OECD.
12. To be classified as a SME in the service sector, the maximum sales ceiling was quadrupled from 5 billion won to 20 billion won in finance, insurance, IT, and medical and welfare services.
13. Of Korea's 1 083 business lines (of which 529 are in services), three are entirely closed to FDI, while restrictions apply to another 26 (primarily in services).
14. In 2008, the government enacted a law which will prevent unjustified discrimination against older persons in recruitment or employment from 2009 and age discrimination with regard to working conditions such as wages and welfare from 2010 (KOILAF, 2008).

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ANNEX 1.A1

The 2008 crisis: a case of déjà vu *for Korea?*

The rapid depreciation of the won in 2008 brought back memories of the 1997 crisis, when Korea, along with two other Asian countries, turned to the IMF to avoid defaulting on their external debt. Indeed, the won declined by 39% in effective terms between the first and fourth quarters of 2008, recalling the 66% drop between the third quarter of 1997 and the first quarter of 1998 (Figure 1.A1.1). In 1998, output collapsed by 7.8% (quarter-on-quarter) in the first quarter, its largest fall since the beginning of Korea's national account statistics in 1970. In 2008, it recorded the second-worst drop of 4.5% in the fourth quarter. There was criticism that the government, corporate and financial sectors had failed to reform sufficiently following the 1997 crisis, forcing Korea to repeat the painful adjustment process only one decade later (Huh, 2009).

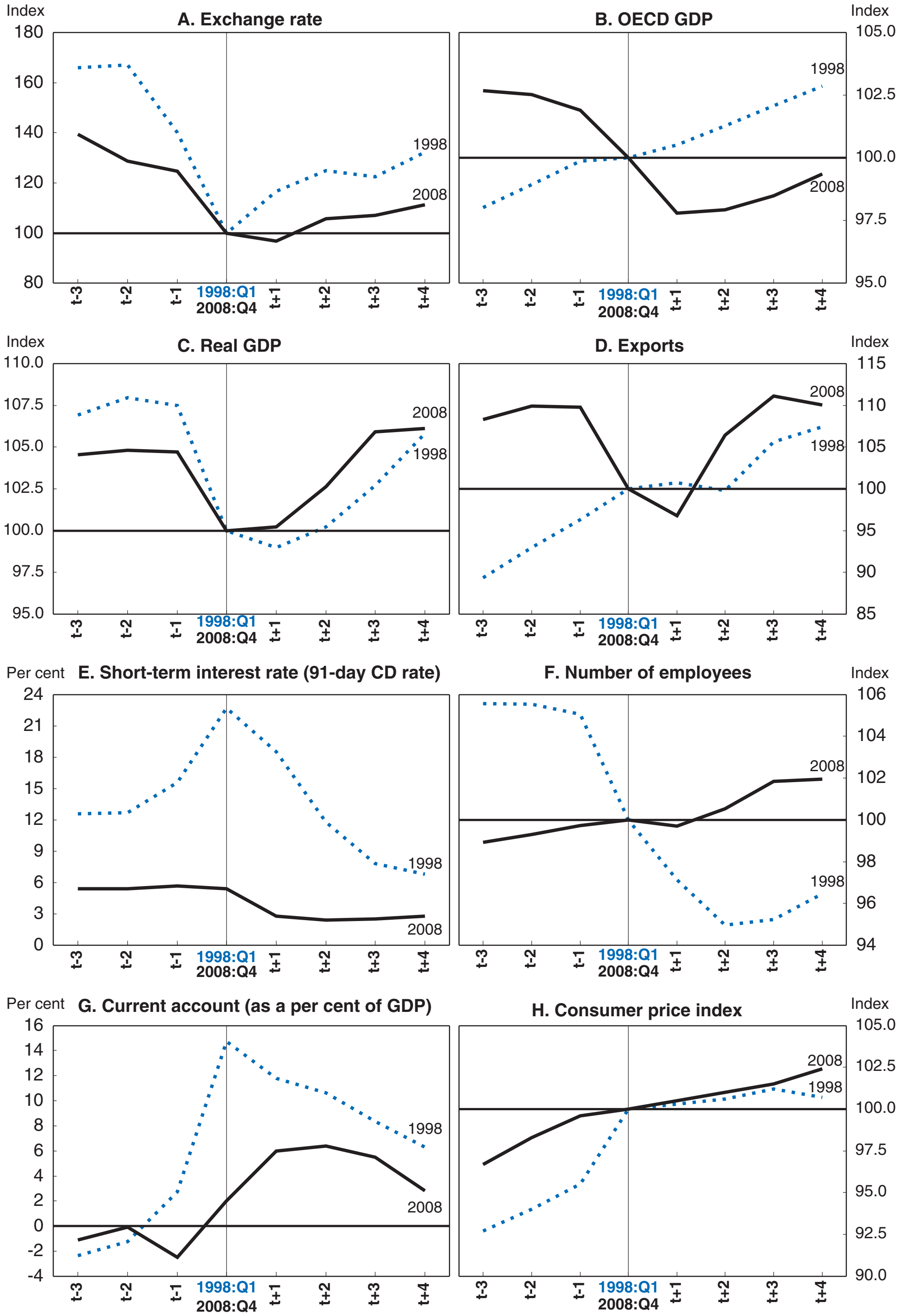
However, the underlying causes of the two crises in Korea were very different. The 1997 crisis was triggered by the implosion of the internal financial market, while the 2008 crisis was mainly triggered by the collapse of the external financial market (Cho, 2009). The different origins of the 1997 and 2008 crises are evident in the divergent paths of the world economy during the two episodes. The 1997 crisis was Korea and Asia-specific, while failing to disrupt strong growth in the OECD area at a 3.3% annual rate between 1996 and 1999 (Figure 1.A1.1, Panel B). In contrast, the 2008 crisis was a global shock that led to the deepest downturn in the OECD area in many decades.

In 1997, foreign investors lost confidence in Korea as a result of weaknesses in its corporate and financial sectors. Profitability was very weak in the 1990s, even before the economy started slowing, and the debt-to-equity ratio was nearly 400% in the manufacturing sector in 1997 (Table 1.A1.1). Such high leverage lowered the interest-coverage ratio to close to 100%, indicating that the average company barely covered its interest expenses – let alone principal – with the cash flow from its operations. The precarious state of the corporate sector led to a sharp rise in the bankruptcy ratio from 0.1% in 1996 to 0.4% in 1997.

The corporate-sector problems were reflected in the banks that lent to them. Banks went into the crisis with insufficient capital as a result of consistently low or negative earnings and the burden of large non-performing loans, which amounted to 4% of their lending in 1996. In addition, Korea's short-term foreign debt doubled to USD 76 billion between 1994 and 1996, reflecting a regulatory framework that favoured short-term over long-term borrowing. Much of the borrowing was by "merchant banks", wholesale financial institutions that operated in a regulatory blind spot. Short-term debt before the crisis erupted in 1997 was more than double Korea's foreign exchange reserves, which had been squandered by the government's futile attempts to defend the won's exchange rate (Figure 3.8).

Figure 1.A1.1. **Comparison of the economic recoveries from the 1997 and 2008 crises**

1998 first quarter and 2008 fourth quarter[1] are set at 100



1. These quarters were chosen as they recorded the largest output declines and won depreciation.

Source: OECD Economic Outlook Database.

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Table 1.A1.1. **Corporate and financial-sector indicators**

	1996	1997	2006	2007
A. Corporate sector				
Return on assets (in per cent)				
All firms	0.5	–0.9	6.8	7.3
SMEs	0.7	–0.6	3.3	3.5
Debt-to-equity ratio in manufacturing (in per cent)				
All firms	317.1	396.3	98.9	97.8
SMEs	387.4	418.4	132.6	129.1
Interest-coverage ratio (in per cent)[1]				
All firms	112.0	129.1	439.3	469.8
SMEs	100.9	99.0	282.9	267.9
B. Banking sector[2]				
BIS capital ratio	9.1	7.1	12.8	12.3
Return on assets (in per cent)	–0.9	–3.3	1.1	1.1
Non-performing loan ratio as per cent of total lending	4.1	6.0	0.7	0.6

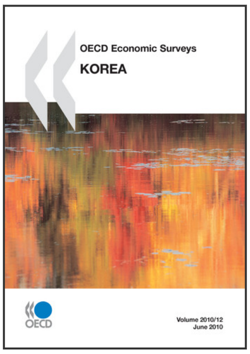
1. The ratio of operating profits to interest expenses.
2. Commercial banks in 1996-97. All banks in 2006-07. As a per cent of total lending.
Source: Financial Supervisory Service.

The corporate and financial sectors were in far better shape by the time of the 2008 crisis. Firms had sharply boosted their profitability and reduced their average debt burden to below 100%, helping to push up their interest-coverage ratio. The improved financial situation enabled the corporate sector to overcome the 2008 crisis without the wave of bankruptcies that occurred during the first episode. Meanwhile, the banking sector was better capitalised, more profitable and had lower non-performing loans, putting it in a much better position to cope with the much smaller impact from the second crisis. The difference between the two crises is illustrated by the amount of public funds needed for restructuring. By the end of 2000, the Korea Asset Management Corporation (KAMCO) had spent 37 trillion won (7% of 1997 GDP) to purchase impaired assets, while the Korea Deposit Insurance Corporation had spent 54 trillion won (11%) to recapitalise financial institutions and reimburse depositors in failed institutions. In contrast, only 7 trillion won (0.7% of 2009 GDP) has been spent thus far to recapitalise financial institutions and purchase impaired assets following the 2008 crisis (Chapter 3).

Despite the depressed global environment, the Korean economy grew slightly more during the four quarters following the 2008 shock (6.1%) than during the four quarters from early 1998 (5.8%) (Panel C). One factor was a somewhat stronger rebound in exports following the 2008 crisis (Panel D), despite the smaller depreciation of the won. This may reflect the increased concentration of Korean exports in medium and high-technology products and closer trade ties with China. Indeed, China's share of Korean exports (including Hong Kong, China) tripled from 10% in 1997 to nearly 30% in 2009.

A second major difference between the two crises was the policy response. During the first crisis, the Bank of Korea raised its policy rate to as high as 30% in an attempt to reverse the won's depreciation, leading to sharp spike in short-term rates (Panel E). The impact of such high rates on a highly leveraged economy was devastating, resulting in the bankruptcy of 58 large corporations in 1997 alone. In contrast, the central bank responded to the 2008 crisis by cutting its policy rate to a record low of 2%. There was also a major difference in the fiscal policy response. In 1997, the government initially cut spending and raised taxes in a misguided attempt to balance the budget that was only reversed once the severity of the downturn became evident. In 2008, the government responded promptly with the largest fiscal stimulus package in the OECD area. This included a significant number of additional public employment jobs, helping to support household income and consumption. Indeed, the number of employees increased by 2% in the year from the fourth quarter of 2008, compared to a drop of nearly 4% during the 1997 episode (Panel F), which lifted the unemployment rate to above 8%. In contrast, the unemployment rate remained below 4% in 2009.

Thanks to government policies, domestic demand has been stronger in the wake of the 2008 crisis. Consequently, the spike in the current account surplus – which reached 14% of GDP in the first quarter of 1998 – was smaller in the 2008 episode (Panel G). In addition, the inflation performance has been different. Consumer prices increased by 2.4% in the year from the fourth quarter of 2008, compared to almost no change in the earlier episode (Panel H).



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