2nd Korea-OECD Conference

Korea's Five Years in the OECD:

Finding a New Path

13-14 December 2001
Seoul, Korea

Ministry of Foreign Affairs and Trade
Korea Institute for International Economic Policy

2nd Korea – OECD Conference

Korea's Five Years in the OECD:
FINDING A NEW PATH

13-14 December 2001
Seoul, Korea

Ministry of Foreign Affairs and Trade
Korea Institute for International Economic Policy

KOREA INSTITUTE FOR
INTERNATIONAL ECONOMIC POLICY (KIEP)
300-4 Yomgok-Dong, Seocho-Gu, Seoul 137-747, Korea
Tel: (822) 3460-1178 Fax: (822) 3460-1144
URL: http://www.kiep.go.kr

Conference Proceedings 01- 02
Seminar held December 13-14, 2001 at The Hotel Shilla in Seoul, Koera
Published December 30, 2001 in Korea by KIEP
© 2001 KIEP

On the occasion of the fifth anniversary of Korea's accession to the OECD, the Ministry of Foreign Affairs and Trade has organized, in collaboration with the OECD, the Conference on *Korea's Five Years in the OECD: Finding a New Path*, which was held in Seoul on December 13-14, 2001.

This conference encompasses three subjects – OECD's contribution to Korea's Economic Policy Formulation, Structural Adjustment and Systemic Risks, Sustainable Growth and the Role of Human Capital. This conference volume is published on the joint responsibility of the Ministry of Foreign Affairs and Trade (MOFAT) and the Korea Institute for International Economic Policy (KIEP).

Table of Contents

OPENING SESSION

Opening Remarks

Doo-yun Hwang
Minister for Trade
Ministy of Foreign Affairs and Trade

Good morning!

I am delighted to announce the opening of the Second Korea-OECD Conference. I would like to welcome to this conference, Director General Witherell, his colleagues from the OECD, Ambassador Young Soo-gil ((our former representative to the OECD)), Chairman Kim Ki-hwan, ((President Lee Kyung-tae,)) and all the distinguished guests.

I would like to note that we certainly miss Ambassador Han Duck-soo, who was my predecessor in opening this conference last year and, up until becoming the Chief Secretary to the President for Policy Planning about a month ago, was scheduled to speak at this conference as Korea's representative to the OECD.

This Second Korea-OECD Conference commemorates the 5th anniversary of Korea's entry into the OECD. We have two things in mind for this seminar. First, we hope to assess what Korea has achieved over the past five years as an OECD member and we hope to identify what we want to further achieve in the future. Second, we want to broaden the Korean people's understanding of the overall trends in international economic governance of which the OECD has been at the forefront.

With these two objectives in mind, we will discuss three broad themes at this conference: first, the OECD's contribution to Korea's economic policy formulation; second, current structural adjustment and system risks; and third, sustainable growth and the role of human capital.

These three themes converge into one question. How can we better adapt ourselves to the ever-changing global economic environment and build an advanced socio-economic system in Korea? And here, I would like to briefly share with you my perspective on this key question.

To begin with, what do we mean by "the ever-changing global economic environment"? Four issues come to mind: The first is the continuing globalization, which is intensifying the interdependence among national economies. The second is the continuing trend towards technological advancement that is speeding up globalization and the emergence of a knowledge-based economy. The third relates to many social and environmental agendas resulting from the increasing activism of the civil society. And, the fourth is the issue of so-called market abuses, such as harmful tax practices and money laundering, that are being increasingly brought to our attention.

Then, what are we — the world community — doing to deal with the ever-changing global economic environment? First of all, the world community has focused its attention on working together to overcome the negative side effects of globalization. For instance, we are addressing the domestic and international economic gap issues. The launch of the WTO Doha Development Agenda last month and the UN International Conference on Financing for Development scheduled for this coming March in Mexico are such examples.

Also, the world community is working to decouple economic development and environmental deterioration. The OECD's continuous efforts to ensure sustainable development are well known. And, the World Summit on Sustainable Development scheduled next September in Johannesburg is one of the examples that demonstrate the international community's collective resolve on this front.

Furthermore, the world community has been carrying on efforts to deal with and prevent financial crises. The ongoing discussions on new international financial architecture and on the various currency swap arrangements being worked out within the framework of the ASEAN+3 process are such cases.

While working together to overcome globalization's negative side effects, the world community is also working together to maximize its benefits. Particular focus is on the liberalization of trade and investment. As the whole world agrees, the launch of the Doha Development Agenda last month was an outstanding achievement on this front. In addition, of course, we are constantly reminded of the continually growing number of bilateral and regional free trade agreements all over the world. Many believe that — together with WTO-centered multilateralism — these FTAs are also advancing openness in trade on an aggregate level.

Along with the efforts to maximize the benefits and minimize the negative side-effects of globalization, the world community has recently accelerated collective efforts in another area. That is to limit the so-called systemic risks. As the result of the September 11th terrorist attacks, the world was given a strong wake-up call. Especially, we came to realize how vulnerable our global economic system can be to such terrorist activity.

In response, the world community has shown solidarity. On October 6th, the G7 finance ministers came up with a resolution on preventing money laundering and cutting off financial channels for terrorists. On October 30th, in Washington D.C., member countries of the Financial Action Task Force on money laundering supported the earlier G7 action with a follow-up of further detailed action plans.

Now, based on these observations so far, it is all very clear that — despite many uncertainties and challenges — the international community is committed to working together to ensure global economic stability and prosperity. Then, one may ask: "How is Korea contributing to this global effort?"

Korea has focused on three main fronts: First, we are doing our best to promote global openness in trade and investment. Second, we are committed to joining the international efforts to address the negative side effects of globalization. Third, in response to the global trends, we are determined to carry out domestic reform programs in order to build a more flexible, more transparent and more competitive socio-economic system at home.

At the heart of our efforts to promote global openness in trade and investment, is the new WTO Doha Development Agenda. As you recall, the agreement in Doha last month sent a clear message of optimism all over the world, declaring that the world is once more united behind the cause of further promoting free trade. What's more, the declaration made it clear that the WTO's role will be further extended to encompass most areas of global economic activities, with many new rules being brought in under its umbrella.

Korea is particularly encouraged by the gains made in several areas of discussion in Doha, such as anti-dumping actions, the Singapore issues, as well as reduction of tariff and non-tariff barriers in the traditional areas of manufactured goods. For the next 3 years, until the end of the scheduled conclusion of the WTO Doha Development Agenda negotiations, Korea will devote much of its energy to making sure that these negotiations be completed on time and with the results that significantly contribute to further liberalizing global markets.

Clearly, there is no doubt in our belief that the WTO-centered multilateral mechanism offers the best vehicle for achieving international economic openness. However, we also believe that regional cooperation fora can lend significant support to achieving this goal. For that reason, Korea is actively engaged in regional cooperation mechanisms, such as APEC, ASEM, and the ASEAN+3 process.

At the Shanghai APEC Summit in October, leaders of 21 Asia-Pacific economies agreed on action plans to realize the goal of full liberalization in trade and investment in the Asia-Pacific region. Korea joined this effort with strong commitment.

In November, at the ASEAN+3 Summit, the leaders of the ASEAN member countries, together with China, Japan and Korea discussed ways to "[Build] Closer East Asian Partnership" and agreed on several steps toward institutionalizing various cooperation mechanisms. President Kim Dae-jung proposed an intensive study of the various means of long-term cooperation, including the idea of building an East Asian free trade zone.

Within ASEM, which links Asia and Europe, Korea has been also actively seeking ways to promote the freer flows of goods, services and investment between the two regions. This was very well demonstrated especially when Korea hosted an ASEM Summit last year.

In addition to participation in these regional fora, Korea also recognizes the need to promote economic openness through bilateral mechanisms as well. We realize this, as we see the rapidly increasing number of bilateral free trade arrangements around the world. In fact, Korea has been one of the few exceptions to this trend so far. And, as our first step, we have been working on establishing bilateral investment treaties (BIT) ((with the United States and Japan.)) We have also been actively considering bilateral free trade agreements with several trading partners, the first one being Chile with which we are finalizing the details of a Free Trade Agreement (FTA).

As I mentioned earlier, in addition to promoting global openness in trade and investment, Korea is equally committed to contributing to the international efforts to address the negative side effects of globalization.

On this front, we are working to help other developing economies. Particularly, we have been increasing the scale of our Official Development Assistance (ODA). And, we are launching various programs to share our experience of economic development and expertise with others. Especially, with a focus on the Digital Divide issues, we are inviting technical trainees from — and sending Korean training experts to — developing countries. We are also promoting the development issues as a key agenda in regional fora, such as APEC and ASEM.

With regard to the issue of sustainable development, for the past few years we have been working hard to transform Korea's industries into becoming more environmentally-friendly. These efforts will be only further accelerated in the future.

Also, to help build a more stable international financial system, Korea is participating in the G20 discussions as a committed member and is leading discussions within the context of the ASEAN+3 process.

Now, as the third and last focus of our efforts to better respond to the global trends, we are — as I mentioned earlier — carrying out our domestic reform programs with an eye on building a more flexible, more transparent and more competitive socio-economic system in Korea. Recently, the world's leading financial institutions such as Standard & Poor, Moody's, Stanley-Morgan, and Goldman-Sachs have recognized the continual improvements resulting from our ongoing reform efforts. Based on such international recognition, we are absolutely determined to keeping up the pace.

Particularly, we are working to promote deregulation and fair competition in Korea. The facts show that we have achieved a considerable level of deregulation so far, as a result of the past several years of reform efforts. In the future, through even more active participation in multilateral cooperation mechanisms, we will continue to adopt international norms and eliminate regulations in Korea that limit economic freedom and creativity.

With regard to the broad range of efforts to encourage more fair market competition, we have introduced, for the past few years, entirely new sets of rules and regulations for corporate governance, corporate disclosure, and anti-corruption measures in Korea. These efforts were also made possible through active incorporation of global norms and standards laid out by the OECD and other international organizations.

Broadly speaking, the issues of fair competition also include the protection of intellectual property rights (IPR). In the age of a knowledge-based economy, proper IPR protection is critical not only for international businesses operating in Korea, but also for Korean businesses that aspire to become global competitors. We have revised our IPR rules based on international rules and norms, and suggestions from international — as well as domestic — businesses operating in Korea.

We are carrying out these and other efforts to build a more transparent, more flexible, and more competitive knowledge-oriented economy in Korea.

Before I close, let me emphasize a very important point here. In all of Korea's efforts to deal with the fast changing global reality, the OECD is an absolutely essential partner that we can rely on. We all know that the OECD is the forerunner in leading international endeavours to stabilize and improve the global economic system. Everyday, the world learns from the OECD; new rationales behind economic openness, new strategies for sustainable development, new ideas for stabilizing international finance, new directions in assisting developing economies and new vision to help establish a knowledge-based economy.

To Korea, the OECD does much more than offering valuable insight and advice. In fact, at home, we take the OECD's guidance and visions as the bases for our effort in building a world-class economy in Korea. And abroad, we take various OECD fora as essential vehicles for Korea to actively participate in the global efforts to seek common prosperity and stability.

I firmly believe that this Korea-OECD Conference will clearly highlight the enormous importance that Korea places on its cooperation with the OECD. And, I sincerely hope that the discussions here will help us better understand the challenges we face and the directions we need to take in seeking a brighter and more prosperous future for Korea and for the world.

Thank you.

Keynote Speech

Soogil Young
Senior Advisor, Kim & Chang
Former Ambassador of Korea to the OECD

Minister Hwang, Director Witherell, Distinguished Participants, Ladies and Gentlemen!

I am honored to have been invited to give a keynote speech at this seminar which commemorates the 5th anniversary of Korea's accession to the OECD. There have been three Korean Ambassadors to the OECD during the last five years. I have the longest serving record of 2 years and 8 months among the three. This may be the reason why I am here today.

The nature of the OECD, as well as the benefits of Korea's accession to it, have been much disputed among Koreans during the last several years, even after the accession and to this day. Today, I will try to resolve those disputes by answering the questions most often, and rather skeptically, raised by many Koreans about the OECD and Korea.

There are four such questions. They are as follows:

- First, Korea has a long way to go before joining the ranks of the advanced countries in terms of the level of development. Yet, Korea has already joined the OECD! Why? Wasn't Korea's accession in 1996 premature in this regard?

- Second, Korea was struck by a severe financial crisis within a year of its accession to the OECD. Was the accession not a major contributor to the crisis?

- Third, how do the other members of the OECD view Korea? Do they not look down upon Korea as a marginal member?

- Fourth, is the Korean government making good enough use of the OECD? Given their limited English-language proficiency and other limitations, are Korean officials capable enough?

I have encountered these questions time and again during my service at the OECD as well as afterward, even till now. I will try to answer each of them as succinctly as possible.

(a) Wasn't Korea's accession to the OECD premature?

A journalist began his interview with me yesterday by saying that the OECD was a social club of the advanced countries. This is a misunderstanding I had to correct. The view that Korea's accession to the OECD was too early is associated with this misunderstanding.

Contrary to what many people say, the OECD is not "a rich men's club", consisting of rich, developed countries only.

At the time of Korea's accession to the OECD, there were 28 members. Of these, 22 could be counted as developed countries. But the remaining six, i.e., Greece, Turkey, Mexico, Poland, the Czech Republic, and Hungary, had income levels considerably below Korea's. So did the Slovak Republic which joined the OECD last year.

Let us now consider the 22 developed countries in the OECD and recall what their economies were like at the time of their accessions to the OECD (created in 1961) or to the OEEC (created in 1948), the Organization for European Economic Cooperation, which was the precursor to the OECD. Most of the Western European countries which joined the OEEC during the early years following World War II, whether at the time of its creation or after this, were not rich developed countries when viewed by present-day standards. And they were in great economic difficulty as economies ravaged by the war. Japan was obviously an advanced developing country, rather than a developed one, at the time it acceded to the OECD in 1964.

Nothing can be further from the truth than the statement that the OECD is a social club. Rather, it should be considered as a study group of very studious government officials. These officials, as well as the experts at the Secretariat, are hard at work.

The OECD's member governments formed the OECD, or later joined it, in order to work together to promote the continued development and advancement of their economies. The Western European countries and Japan sought in the OEEC and the OECD to help each other rebuild their post-war economies and put them on the path of sustained advancement. The present-day developing member countries have joined the OECD for the same purpose of promoting their economic development with the help of the advanced ones.

In the case of Korea, too, the continuation of economic development was the primary and ultimate goal of the accession.

How does the OECD help its member countries achieve this goal? To see this, it should be realized, first, that the challenge of economic advancement is in reconciling two important values: the market economy and democracy. This, by the way, happens to be President Kim Dae-jung's proposed approach to economic problems and goals.

We, Koreans, are currently suffering from various social and economic conflicts among us. It can be said that the root cause of these stresses is the failure to reconcile the market economy and democracy. Overcoming the consequent tension between the two values is the key to, as well as the meaning of, economic advancement.

The fundamental requirement for membership in the OECD is the acceptance of those two values. And, in the OECD, the officials of the member governments work together to learn and practice how to reconcile and pursue both in a mutually reinforcing way.

To do so, they meet, up to a few times a year by policy area, explain their individual situations for comparison, evaluate different policy approaches which emerge; they, then, identify the best practices, use these to benchmark their individual practices, and offer constructive criticisms as well as policy advice to each other, in the spirit of learning from each other, as well as helping each other.

This OECD process has been described as the peer pressure process. What this means is that there is no legal enforcement in the OECD and self-enlightenment is the main method employed for influencing the member government's policies. Viewed in this way, the OECD is a club for mutual help in the approaches to reconciling the market economy and democracy.

Korea acceded to the OECD at a time when the conflict between the market economy and democracy was at its worst as manifested in the form of escalating economic and social crises. This means that Korea's accession to the OECD was very timely if not overdue.

(b) Was the accession not a cause of the financial crisis?

Some seem to equate the accession to the OECD with the opening of domestic markets. It would be wrong to do so.

It is true that a criterion for admission into the OECD is a commitment to the principle of open domestic markets. But, as a matter of principle, the focus of the OECD's peer pressure process is not on securing the openness of the domestic markets of the member countries per se but on the creation of domestic economic and social conditions which would be conducive to the opening of the domestic markets.

By the same token, the opening of the markets at home was not the principal feature of Korea's accession procedure of the OECD.

The fact of the matter is that an applicant country for accession to the OECD has to undergo a country examination process which covers all major fields of economic policy, and during this process, the existing member countries present requests to the applicant country for commitments for certain policy modifications, including those for certain market-opening measures. Many of such requests are accepted, but not necessarily all.

As an applicant country, Korea underwent such an examination process which covered capital movement, international investment, international trade, banking, insurance policies, labor relations, climate change, environment, and maritime transportation. In this process, the Korean government was presented with many requests, as well as recommendations, for commitment to policy changes.

The Korean government accepted many of those but resisted. And during the first few years since the accession, it has effectively and faithfully implemented all of its commitments, with the sole exception of the commitment on labor laws. The government believes that all the consequent policy changes have been in Korea's national economic interest, leading to a further modernization of the economy. As to the labor laws, the Korean government has found it very difficult to create the social consensus in support of the full implementation of the commitment.

The key issue raised by the question of whether Korea's accession to the OECD contributed to the financial crisis is the specific content of the government's concession on the movement of financial capital. What is true is that the Korean government had taken measures to liberalize the movement of short-term financial capital by the time of its accession to the OECD. It is also true that there was a major flight of such capital out of the country in 1997, causing the Korean financial crisis. The issue is whether those measures on the movement of short-term financial capital were a result of the OECD member governments' request made during the accession process.

There was an internal examination of facts over this issue within the OECD Secretariat in 1998. The finding, which is not inconsistent with the findings from Korea's National Assembly hearings on the financial crisis, is as follows:

OECD member countries asked Korea to: 1) accelerate and broaden the scope of Korea's original liberalization plans for foreign direct investment, including takeovers; 2) permit establishment of subsidiaries by foreign banks and securities firms and further foreign participation in Korean financial institutions; 3) liberalize further other long-term capital flows (i.e., foreign purchases of Korean listed shares and corporate debt securities of one year or more, their issue on foreign markets, long-term financial credits); 4) liberalize bona fide inward credits linked to foreign trade.

In the end, Korea agreed to take certain measures in response, but resisted any significant liberalizing steps regarding inward trade credits and inflows of long-term financial capital. Those steps were taken only after the occurrence of the financial crisis under the IMF's prodding.

With respect to capital outflows, by the time accession negotiations started, the basic freedoms were by and large already in place.

The OECD request represented an encouragement for Korea to shift further away from the old, increasingly inefficient credit allocation system based on banking intermediation and government intrusion to direct corporate finance.

More to the point of the present issue, however, the OECD did not request Korea to liberalize foreign investment in money market securities and other short-term instruments, including derivatives, and short-term financial credits from abroad. The OECD did not request a liberalization of non-resident investment in real estate, which was fully restricted in Korea at the time.

Nor did the OECD request Korea to allow the transfer of foreign funds to Korean banks. This was permitted long before Korea's accession negotiations started. And as a matter of fact, at the time of Korea's accession, the OECD drew the attention of the Korean authorities to the need to modernize the banking system and, in particular, to upgrade the prudential supervisory framework. We all know that those efforts did not begin until after the financial crisis.

The conclusion is very clear: Korea's financial crisis happened because of problems at home and its occurrence had nothing to do with the accession to the OECD.

(c) How is Korea viewed in the OECD as a member?

A criterion for admission into the OECD, other than those already mentioned, is that a member country should be "a major player" in the international economy. The OECD considers Korea as eminently satisfying this criterion. This is why Korea was invited to become a member in the first place.

The statistics released by the Office of Statistics just yesterday show how significant Korea's economy in the world is. Among the OECD countries, in particular, Korea ranks around 10 th in terms of such indicators as population, GDP, and trade volume. Reflecting this, Korea was the 9th largest contributor to the OECD annual budget in 2001, exceeding many European countries in this regard. In addition, Korea is a prominent player in at least a few industries such as shipbuilding, steel, automobile, and semi-conductor, ranking within the largest five globally.

In fact, the OECD hopes that Korea will play an active role commensurate with its rather significant weight among the OECD countries in the study and discussions of global economic problems as well as in the international effort to address these problems.

Thus far, I have emphasized the promotion of mutual support for economic advancement among the member countries as the main role of the OECD. However, there is another, equally important, as well as related, function: it is to promote joint efforts to address global issues such as global business cycles, international trade and investment, multinational corporations, international crime, harmful tax competition, e-commerce, the global climate change, bio food, the new economy, and so on.

All these developments and problems require internationally coordinated efforts to ensure an open and dynamic global economy. The OECD plays the role of the pathfinder on this front. It identifies and explores new global issues, and tries to identify and promote the necessary coordinated response to those issues.

Thus far, however, it has been largely the developed member countries of the OECD which actively participated in these efforts. But these countries very much hope that a new and significant international player such as Korea will also be an active participant in those efforts.

Rising up to such expectations are entirely in our own national interest. Doing so would allow us to contribute to the shaping of a new global order while projecting our own perspective onto this order. It would help us enhance our international political influence.

My own assessment, however, is that we are far less active than we could be in the international discussions of such nature both in and out of the OECD theatre. In this regard, I am pleased that Korea joined the International Energy Agency, an affiliate body of the OECD, as a member early in 2001, and that I could play a catalytic role in bringing this about. Minister Hwang has just now mentioned a number of global economic issues on which the Korean government intends to play an active role. So, we do have encouraging signs. However, I believe that we could be much more ambitious and that we should.

Essentially from the same perspective, the OECD has special expectations of Korea. This takes me to the OECD's interest in non-member countries, i.e., the so-called emerging market countries and the poorer developing countries.

It is the common belief of the OECD countries that they cannot sustain their economic development without the parallel economic development of the non-OECD countries. However, it is not possible to admit all countries into the OECD for the purpose of promoting joint prosperities. Accordingly, what they try to do is to help the non-OECD countries by transferring know-how on economic development and reforms through the so-called policy dialogue programs.

The OECD places a high priority on development assistance to the poorer developing countries. For this reason, the developed member countries have committed themselves to certain levels of official development assistance (ODA) to those countries. They participate in the Development Assistance Committee (DAC) of the OECD to discuss how to improve and coordinate their policies on the administration of ODA.

In addition, many member countries sponsor the Development Centre for the purpose of facilitating the transfer of development know-how to the poorer developing countries through practical research and policy dialogue.

It is true that Korea still has some way to go before becoming a truly advanced country. Many indicators such as income level show this. However, it is also true that Korea is now one of the significant, if not very major, international players. Furthermore, over the time span of a generation, Korea has made a remarkable transition from a very poor developing country to an advanced developing country as well as a significant international economic power. Accordingly, the OECD considers Korea a very unique and remarkable success story for economic development.

The member countries have a high regard for Korea in this respect. They are also impressed by Korea's remarkably rapid recovery from the recent financial crisis and finds Korea exemplary in this regard as well.

Accordingly, first of all, the OECD considers Korea as an encouragement as well as a model to the emerging-market economies and developing countries in general, and for this reason, they sincerely hope that Korea will continue its rapid economic reforms and development, completing the transition to a developed country in the near future. Furthermore, the OECD hopes that Korea will be active in the transfer of the economic reform and development know-how it has acquired, based on both successes and failures, to non-member countries including the poorer developing ones. And in addition, it hopes to see Korea's more active material contribution to development assistance.

My own assessment is that, in regard to the last two points, Korea can and should do much more than it has been doing.

Korea should be more seriously interested as well as more active in the OECD's cooperative relationship with non-members. The policy dialogues with such countries as China, Russia, India, and Brazil, in particular, will offer many benefits.

Korea should be able to double its ODA as a proportion of GDP from its current level of 0.05% within the next several years. And, on the basis of this capability, Korea should seek to join the DAC within the next few years.

While serving as Ambassador to the OECD, I had the honor of being appointed by the Council to serve as the Chairman of the Advisory Board on the Development Centre. And as such, I tried to support the Centre by helping to reform it to be better focused. But this was a personal contribution. Korea's contribution to the objective of the Centre, the transfer of development know-how through policy dialogue, has remained weak.

The issues associated with poverty which are addressed by the DAC and the Development Centre are key components of the international discussions agenda on global governance. By staying out of the DAC, and remaining passively engaged in the international discussions of the problem of the poorer developing countries, Korea is choosing to remain on the sidelines in the management of global economic affairs and to forego a considerable amount of international political influence in and out of the OECD circle.

(d) Is Korea making good enough use of the OECD?

Whatever limitations there may be in the abilities of the Korean officials, there is no doubt that the Korean government has made very good use of the OECD, and especially its peer pressure process, in the process of overcoming the financial crisis and reforming the Korean economy. Along with the IMF, the OECD has provided an extremely valuable service to Korea in this regard.

In this sense, during the four years since the outbreak of the financial crisis, Korea has been the greatest beneficiary of the OECD's function as promoter of mutual support among its members for economic development. And, as a matter of fact, Korean officials have worked hard and most capably, in order to bring about this result. In this regard, they have been exemplary, when compared against their counterparts from other member countries.

I would be grossly remiss if I did not also mention, as I mention Korean officials, the most serious and very dedicated support, as well as the high quality analyses, that have been rendered by the highly capable experts at the Secretariat. The Korean government should be, and is, very grateful to them for such support.

In the present context, I should also mention that the OECD expressed its doubt in 1998 about the efficacy of the so-called Big Deal and the regulatory approach to the problems of the chaebol. In this sense, it anticipated the current debate on those issues in Korea.

It has been pointed out that, in the other interest areas of the OECD, that is, on global governance and the poorer developing countries, the Korean government has been more or less passive. These are matters on which the Ministry of Foreign Affairs and Trade should play the leadership role.

Conclusion

It is true that we still have a long way to go in order to complete the transition to a market-based economy as well as toward a knowledge-based economy. At the same time, we should not neglect being an active contributor to the management of global affairs.

This means that we should try to do much better as a member of the OECD, in order to reap the benefits of the membership to the fullest extent. To mention some of what should be done for this purpose:

First of all, we should see the significance of the fact that we are the 9th largest contributor to the budget of the OECD. We should equip ourselves with the commensurately strong sense of ownership of the organization as a significant player in the global community.

Korea is no longer a new member. It is not a small or weak member, either. It is one of the important share holders, a member of the board, as it were, of the organization, as well as of the global community.

We are no longer a *taker*. We are a *shaper*.

In order to be able to exercise our due share of influence in the work of the OECD, as well as make our due share of contributions, we should be intellectually better prepared.

Among the high priority requirements are:

willingness to participate actively in the management of the organization, including in the identification and prioritization of projects,

the creation of a well-networked and active system of studies and discussions among mid-level government officials over the range of issues emerging among the OECD countries,

the nurturing of the culture and habit of democratic, free, substantive, and in-depth debate and discussion among officials regardless of their ranks.

The rapid rotation of officials between areas of responsibility is highly destructive in all those regards. It is something that we should not be proud of.

Ministers themselves should remain well briefed about the OECD work in their own areas. They should not ignore neglect attending the OECD's Ministerial meetings. And they themselves, rather than their deputies, should be willing to be active participants in those meetings.

In closing, I very much hope that the present Korea-OECD Seminar will serve as an occasion for the Korean government to launch a serious review of all those requirements.

Thank you.

Keynote Speech

William Witherell
Director for Financial, Fiscal and Enterprise Affairs
OECD

Introduction

It is indeed an honour for me to speak at this conference marking the fifth year of Korea's membership in the OECD. It is also with great satisfaction that I greet this anniversary for, as some in this room will remember, I was one of the early supporters of Korea joining the OECD. It was evident to me in the early 1990's that membership promised great benefits to both Korea and the Organisation. Today and tomorrow we will be considering the extent to which this promise has been realised and the path forward.

The OECD brings together 30 member countries sharing a common commitment to democratic government, the market economy and the protection of human rights. It is this commitment and the willingness to engage in policy dialogue and in peer review processes and to work towards achieving consensus that are at the very heart of the OECD. As I will be discussing later, these are areas in which Korea has excelled in its first five years of membership.

It is important to understand a critical distinguishing characteristic of the OECD – its committee structure. The organisation operates largely through standing intergovernmental committees and working groups that cover most areas of public policy. The delegates to the major committees are senior officials from capitals who, along with their experts, form global policy networks that constitute a fundamental strength of the OECD. Membership in the OECD means a seat at the table in these groups where experiences are exchanged and analysed, best practices are identified and, in some cases, international standards and rules of the game are developed and implemented.

I wish to emphasise that the OECD is not a closed club. With active relationships with some 70 other countries, international organisations and civil society, it has a global reach. These relationships are invaluable, first, for providing a broader perspective for OECD's analysis and the development of policy recommendations, second, for sharing knowledge and experience with developing and transition economies about how to make market economies function better, and, third, for achieving a wider acceptance or "buy in" of principles and policies recommended by our Member countries. Participation in these "outreach" activities has proven to be an important benefit of OECD membership.

Korea in the Global Economy

While some refer to the OECD as a club of the rich or most developed nations, these commentators ignore the fact that the membership includes countries like Turkey, Hungary and the Slovak Republic, our newest member. There can be no doubt that the characteristics of the Korean economy fall well within the range of those of our other members. Indeed, Korea's GDP ranks 10th among the OECD economies, and seven of the members have a smaller GDP per capita.

But more impressive than the sheer size of the Korean economy is the remarkable history of the resurgence of the economy from the ashes of war in the 1950s and the "policy courage", hard work and tenacity that has been demonstrated again by the Korean people and your government more recently in facing the Asian financial crisis.

(If you will allow me a personal aside, I must commend also Korea's rapid commitment to assist in a meaningful way in the war against terrorism. This is clear evidence that Korea's partners can be confident of this nation's support when a serious need arises.)

The Asian financial crisis struck Korea less than a year after it joined the OECD. While many of the structural weaknesses that were laid bare by the crisis were already known, the extent of some of the financial imbalances were not, and the occurrence of the crisis in 1997 was largely unexpected. In the first seven years of the decade of the 90's the earlier Korean development model in which government made the big resource allocation decisions was becoming less relevant and increasingly unworkable. Growth was slowing despite a rising investment share in national income. Export competitiveness and corporate profitability were lagging while current account deficits increased and, of particular importance, corporate leveraging soared to what proved to be unsustainable levels. Due to the subordination of finance to industrial objectives, prudential supervision was neglected.

In contrast, this was a period when the OECD countries plus a growing number of non-members were converging on an economic model in which markets were assigned a much larger role in resource allocation while the state was assigned the task of building a strong institutional, regulatory and legal framework. Within the OECD, consensus was building on issues such as corporate governance standards, privatisation, and liberalisation of capital movements and market access. In parallel exercises, international standards were agreed in banking supervision, securities and insurance.

In response to the 1997 crisis, the Kim Dae-jung Administration opted for the emerging international consensus on economic policy, that is, the model to which other OECD members had converged. The Korean approach involved both the incorporation of best international practice into Korea as well as the development of new techniques to address crises. The OECD has been a major channel of communication between Korea and major players in the world economy as the reforms were developed and implemented. Membership in the OECD provided both access to expertise in other countries and a valuable means of communicating Korea's achievements

A number of the reforms have involved important policy areas for the OECD and provide good examples of Korea's participation in OECD activities and of how the OECD has benefited from Korea’s membership. I would like to comment on several of these areas, beginning with those you will be discussing in more detail later today.

1. Financial Reform

The Korean financial reform has reflected 1) the immediate need to overcome the crisis that erupted in 1997 and 2) the longer run goal to recast the financial system from a function of passively supporting industrial policy to one of disciplining the corporate sector and contributing actively to resource allocation

A fully independent supervisory institution -- the Financial Supervisory Commission -- was established, supported by its executive arm the Financial Supervisory Service. The Commission imposed progressively rigorous supervisory standards based on international norms. The establishment of an independent agency for financial supervision was consistent with the OECD consensus. However, the decision to concentrate all financial supervision in a single agency was Korea’s own choice from among several institutional models currently in use in OECD countries. As the experience with institutional arrangements for financial supervision among Members is currently being evaluated, the Korean experience will be closely watched by other countries.

Yet despite the expenditure thus far of very large amounts on financial rehabilitation, the task is still only partly completed. On the positive side, the Supervisors have demonstrated their commitment to upholding high supervisory standards and have kept their independence while the Financial Supervisory Service has developed strong skills in implementing prudential oversight. The Korean Asset Management Company (KAMCO) has emerged as a highly effective loan resolution agency. A number of strong Korean banks have also emerged, that are well capitalised, well managed and capable of adapting to new challenges. These banks have credibility with international investors. Since many Asian countries do not have such a core of strong banks, this is a noteworthy achievement.

At the same time, more than half the banking system is still not capable of meeting balance sheet tests using rigorous standards. These banks, which are mainly government owned, are saddled with high levels of loans to corporate entities that are themselves marginally solvent. There are also serious problems outside the banking sector, including a number of insurance companies have difficulties meeting standards of solvency and persistent difficulties in the collective investment industry, which is a growing repository of savings in most OECD countries. Finally there is a serious problem of solvency in the corporate bond market, which has already required a major government rescue. Further structural reforms are needed before the bond market can perform an effective role in financial intermediation.

One important lesson that can be drawn from Korea is the close connection between financial reform and corporate reform. The problems that are now visible in the banking system and the corporate bond market stem from the problems of excessive leverage and declining profitability that arose in the early 1990s. As the creditworthiness of the industrial conglomerates deteriorated, the banks and the bond market both were adversely impacted. The ambiguities concerning final responsibility for failing companies that existed under the old system undoubtedly deterred the banks and bond investors from exercising discipline over the corporate sector as the situation worsened.

The OECD has been actively involved in the Korean financial reform. During the period when Korean membership in the OECD was under discussion, OECD Committees and working parties urged Korea to modernise its financial market, to liberalise the capital account and to upgrade its arrangements for supervision. Following accession and particularly following the 1997 crisis, various OECD groups have encouraged Korea to persevere in the path of reform it chose in late 1997 while monitoring its performance. In many cases, the practice of other OECD countries was helpful in the context of Korea. Meanwhile, as Korean practice showed good results in areas such as bank rehabilitation and the resolution of non-performing loans, that Korean practice became incorporated into OECD standards of practice.

2. Liberalisation of Capital Movements

The OECD has 40-years of experience with external financial liberalisation within its membership constituency. Overall, this experience has been positive, in view of the benefits of capital account liberalisation in stimulating economic growth and efficiency. The many concrete advantages of external financial openness in terms of allowing diversification of portfolios and financing sources, raising competition and fostering improved transparency and disclosure standards for domestic entities have been seen as outweighing any transitional costs and dislocations.

For Korea, the process of capital account liberalisation has also proved to be a catalyst for further economic reform, but unfortunately it was initiated just before one of the most severe financial crises ever experienced among OECD members. A build-up of large short-term debt and excessive foreign currency exposure in financial institutions as well as enterprises was facilitated by the timing and what proved to be unwise sequencing with which restrictions were removed. (The OECD advice to liberalise first long-term capital movements, particularly foreign direct investment, was not followed.) When the crisis struck, weaknesses in the financial sector and a lack of creditworthiness and competitiveness in the corporate sector were starkly exposed and compounded by this particular sequencing of the easing of restrictions on capital movements.

This experience has brought added recognition in Korea as well as among other OECD member countries of the need to integrate many dimensions of domestic and international financial policies when undertaking liberalisation. Potential balance sheet vulnerabilities in the financial and corporate sectors deriving from unrestricted capital flows, such as experienced by Korea, were in the case of older OECD members nearly always mitigated by the progressive pace of liberalisation, sequenced with deregulation and reform of the domestic economy. With its rapid, export-oriented economic development, Korea did not have such a long history of orientation towards the market paradigm and consequently less time to build up the appropriate underpinning of institutional-governance structures for a market economy. Learning from Korea's experience, the OECD has been able to provide non-members with policy advice for their liberalisation efforts, aiming to ensure that they are adequately supported by governance and institutional reforms, especially as regards prudential supervision. Even so, vulnerability to crises can of course never be fully eliminated.

3. Foreign Direct Investment

The potential benefits of foreign direct investment have come to be recognised by countries all around the world. Governments take active measures to attract FDI, in order to capture its direct growth impetus and job creation as well as the transfer of technology and skills which often come with FDI. When Korea acceded to the OECD in 1996, it was strongly encouraged by OECD Members to relax its existing restrictions on FDI. Openness to FDI in the most general sense was urged, meaning not only the absence of direct restrictions, but also that the overall regulatory and administrative framework for foreign entrepreneurial activity should be simple and user-friendly. Many measures aiming in this direction were undertaken as part of Korea's accession process to the OECD and were accelerated further in response to the financial crisis. That event demonstrated the additional role of FDI as a vital source of stable and long-term financing. The stated policy of the current Government is to have in place a transparent, non-discriminatory regulatory framework for investment, whether foreign or domestic. The OECD applauds the example that Korea now is setting in the investment field for the rest of the world, in particular, for the other economies of the Asian-Pacific region.

4. Corporate Governance and Reorganisation

Corporate governance and corporate affairs policies provide another good example of how both Korea and the OECD have benefited from Korean accession. After the financial crisis, Korea initiated an unprecedented shift of the basic paradigm for corporate development--of how corporations are organised, controlled, financed and regulated. While implementation of these reforms is far from over, Korean policy-makers have made a strong commitment to change--and have put a considerable amount of political capital behind it.

OECD membership played a key role in this paradigm shift. Contrary to some of its Asian peers ,the Korean political leadership--especially President Kim Dae-jung -- realised immediately after the outbreak of the crisis that Korea's answer to the crisis could only be convergence towards best OECD standards. Senior Korean officials looked at OECD countries for precedents and welcomed OECD advice on change. The majority of the recommendations on corporate sector reform contained in the OECD Economic Surveys of 1998 and 1999 were taken up by the government. In 1999, a government appointed commission recommended sweeping revisions of relevant laws and practices, largely based upon the practices of OECD countries and the OECD Principles of Corporate Governance. As a result, Korea:

- Modernised its company law, including important minority shareholder rights and director duties
- Changed its accounting system, and thus increased transparency and the possibility for investors to understand the labyrinthine control structure of the chaebols
- Took steps to improve the design and implementation of bankruptcy laws, by adopting a special out-of-court procedure for large debtors and by establishing a special chamber to deal with insolvency cases in the Seoul district court.

On the policy side, the government also looked at OECD recommendations. It pushed hard to lower the leverage of corporations towards what it deemed to be internationally acceptable debt to equity ratios of 200 and to improve the financial discipline exerted by banks. The result was the justified demise of some very big and very sick companies. Under the old paradigm, these companies would have been bailed out ad infinitum; now they are being sold to investors, including foreign investors, who can make the most out of their assets and put a lot of Korean people back to work. Of course, progress has not always been rapid, nor even, nor unopposed (Randy Jones will discuss some of the remaining problems). But these problems should not hide the fact that the Korean leadership made convergence with the OECD mainstream a central task. This direction has paid off well: amidst investor concerns for the region as a whole, Korea has received relatively high marks for its reform efforts.

But the Korean accession has also considerably helped the OECD develop its own understanding of corporate affairs issues. Up until 1996, these areas had not yet come to the forefront of policy. While different parts of the OECD house were analysing their economic impact, their public policy aspects were still being defined. There were no OECD bodies or policy fora specifically devoted to these issues. The Korean administration, realising the importance of getting it right in the corporate sector, became a force for deeper OECD policy reflection and action in the area. More specifically:

- Korea was one of the first and firmer supporters of the drive to draft a set of OECD Principles of Corporate Governance which then provided a framework for Korea's reform. As you know, these Principles were not only finalised successfully and in record time in 1999, but have gone on to become the global benchmark, used by governments, international organisations, stock exchanges, investors and corporations. As mentioned above, the Principles were directly used in proposing the framework for the reform of corporate governance.

- Korea was a firm supporter of the establishment of an OECD Steering Group on Corporate Governance to ensure a regular exchange of experience on corporate governance reform and to help implement the Principles around the world, in both member and non-member countries.

- Korea hosted a key conference on Asian Corporate Governance, in 1999. The Seoul conference turned out to be the inaugural meeting of the Asian Corporate Governance Roundtable, the most important regular dialogue event in Asia, supported by the OECD, the World Bank and the ADB. The main task of the Roundtable is to set the agenda for corporate governance reform in the region. Korea participates actively in this forum. Korean experience serves as an important input to other Asian governments and market players.

- Korea was a founding member of the Forum for Asian Insolvency Reform (FAIR). Insolvency has been an area where important progress has been achieved, even more than in the corporate governance area. Thus, Korea's successful experience with insolvency reform has greatly benefited the other members of FAIR.

5. Competition Policy and Regulatory Reform

Yet another area in which the Korea/OECD relationship has had particularly great mutual benefits is competition policy. In 1997, Korea was quick to recognise that inattention to competition policy issues had been a major factor in turning what began as a financial crisis into an economic crisis. Korea's decisive response – guided by its own competition policy experts at the Korean Fair Trade Commission (KFTC) and the Korean Development Institute (KDI), as well as by OECD – brought quick benefits to its citizens. Moreover, Korea's generosity in sharing its experiences with other countries has been a major reason for the success of the OECD competition policy outreach programme, in Asia and globally.

The response to the crisis illustrates well the virtuous circle created by Korea/OECD co-operation. There is a long list of steps Korea has taken to make its own economy more competitive: I will emphasise just a few. In 1999, less than a year after the OECD issued its Recommendation on Effective Action against Hard Core Cartels, Korea enacted its Omnibus Cartel Repeal Act. This Act enhances consumer welfare and encourages competition in markets by abolishing or diminishing concerted activities which had been granted exemptions from sectoral legislation. Also, during the process of the privatisation of state-owned enterprises, the KFTC acted to increase competition and ensure that privatisation did not end up merely changing public monopolies into private monopolies.

The KFTC also played a key role in a comprehensive OECD review of Korea's regulatory policies. Competition policy has been made a cornerstone of Korea's regulatory system because competition policy can be used as a tool for evaluating the least costly and most effective way to reach other regulatory goals. The OECD Report on Regulatory Reform in Korea was released in Seoul in June 2000. It assesses the Korean government's reform efforts, and recognises what remains to be done, for example, the continuing need to solve the "chaebol problem", which should be pursued through market principles rather than direct intervention. More generally, the Report praises recent initiatives and indicates that Korea is a front-runner among Asian countries in the area of regulatory reform. However, it also stressed the importance of maintaining and re-energising the momentum behind the reform efforts in the coming years, particularly now that leaner days are setting in.

I have been impressed by Korea's willingness to share its experiences in the competition policy area both within the OECD and in public forums around the world. The continuous and valuable Korean participation in the OECD Competition Committee was reflected in the election this year of the KFTC's Delegate, Mr. Seon Hur, to the Bureau of the Committee.

More broadly, Korea has been sharing its experiences while acting as a "bridge" between the OECD and developing countries. Even before the 1997 crisis, Korea had joined with the OECD in co-sponsoring an annual competition policy workshop in Seoul. The workshop began as an event for APEC countries, but it has increasingly attracted a broader geographical range of participants. This year an equal number of Asian and European economies took part. Moreover, at these workshops, Korea has been very candid in acknowledging the problems created by its past policies. This candour has been very helpful in demonstrating to other economies the importance of competition law and policy. Finally, I would be remiss if I did not mention the important intellectual, moral, and financial support Korea has provided to the newly created

OECD Global Forum on Competition. We particularly appreciated KFTC's chairman, Lee Nam–kee, coming to that important OECD event, despite grievous personal circumstances. Let me convey again to him my deep condolences.

6. Tax Policy

It became clear during the accession process that that the tax policy area would be an important field for Korea-OECD co-operation. Since accession, Korea has renegotiated its main tax treaties with a number of other OECD trade partners, such as UK, Japan, Germany, US and Australia. The negotiations were based on the OECD Model Tax Convention. Further, Korea has also used the Model Tax Convention as a basis for treaty negotiations with other Non-OECD countries. Since the OECD Model Tax Convention focuses on more fluent movement of cross-border trade and investment, Korea's new treaty network will contribute to accelerate foreign investment and technological development in Korea by reinforcing international economic ties with other treaty partners.

Korea also has aligned its international tax regime with tax principles and guidance developed and recommended by the OECD. The highlight of such efforts is the adoption and implementation of the Law for Coordination of International Tax Affairs in 1996. This law covers a number of international tax issues such as transfer pricing, thin capitalization, controlled foreign companies, mutual agreement procedures and international cooperation. The law can be seen as a good example of OECD's contribution to Korea in the tax policy area. Tax experts from other OECD Member countries and the OECD Secretariat provided technical assistance to the Korean tax authorities in order to assist them overcoming any technical pitfalls with regard to the legislation.

The OECD Secretariat has recently carried out a comprehensive survey of Korea's domestic tax policy and administration as part of the annual country reviews. In September of last year the country report on the Korean economy was issued, providing in-depth analyses on the current status of the Korean tax policy and administration and future policy options. The recommendations in the report may be helpful in the national policy considerations.

I wish to applaud the important role Korea has played in bridging the gap between OECD Member countries and Non-Member economies in the Asian region through the Korea-OECD Multilateral Tax Centre. This Centre was established in Korea in September 1997 under the initiation of Korea. So far, the Centre has held 22 tax seminars on important topics in the international tax field and hosted over 400 participants and experts from 30 different Asian countries. This Centre has taken a strong initiative in developing and maintaining a network of tax administrators in Asia through publishing periodical newsletters and directories with detailed contact information of the participants. These are circulated not only to the participants of the past Korean seminars but also to all tax authorities in Asia. This valuable initiative is very unique.

7. Anti-corruption

In 1998, Korea's President, Mr Kim Dae-Jung, publicly committed his government to combating and eradicating corruption in the public and private sector via the announcement of a comprehensive national anti-corruption program. Subsequent to his entry into office, a comprehensive national anti-corruption program was developed and numerous anti-corruption efforts have been undertaken to implement it including:

- Administrative reforms;
- Setting-up of an independent anti-corruption office reporting directly to the Prime Minister;
- Promoting of public awareness and increasing civil participation against corruption;
- Adopting anti-corruption laws;
- Strengthening international co-operation to combat corruption.

Korea's commitment to combating international corruption is reflected in its adoption of legislation implementing the 1997 OECD Bribery Convention as well as in its active participation in the OECD activities to fight corruption in international business transactions. Whereas Korea is one of the most recent OECD Members, it was among the first to pass legislation implementing the OECD Convention in national law. The Foreign Bribery Prevention Act (FBPA) was passed on December 28, 1998, and the government deposited its instrument of ratification of the Convention with the Secretary-General on 4 January 1999. Korea also volunteered to be one of the first lead examiners under the implementation process of the Convention and has carried out this task effectively.

Korea has assumed a leading role in developing the dialogue with non-members in the battle against corruption. The Office of the Korean Prime Minister was instrumental in the organization and support of the regional conference on "Combating Corruption in the Asian-Pacific Region", which was held in Seoul in December 2000. The main outcome of the Seoul Conference was to call for some concrete action by countries of the region to fight corruption under three pillars: 1) governmental accountability and transparency, 2) anti-corruption and anti-bribery actions in business transactions, and 3) civil society involvement. This action plan has now been endorsed by 17 countries of the region at the latest annual meeting of the Initiative that concluded several weeks ago in Tokyo.

Korea has been chosen as host country for two major global anti-corruption events in 2003: the Third Global Anti-corruption Forum and the International Anti-Corruption Conference (Transparency International). This confirms Korea's desire to be actively associated with the international fight against corruption and to highlight the accomplishments of its national anti-corruption program.

8. Environment

With respect to the OECD's work on environment policies, I would like to mention the challenging issue of climate change. Korea was not a member of the OECD at the time the Framework Convention on Climate Change was agreed (1992). As a result, Korea was not included in the lists of "developed country Parties" or "other Parties" in Annexes I or II of the Convention (Annex I Parties have emission commitments under the Kyoto Protocol, and Annex II Parties have financial commitments under the Convention). After it became a member of OECD, its status became ambiguous. The result is that Korea today has different commitments under both the Convention and the Kyoto Protocol than most other OECD countries.

This represents both a problem and an opportunity for Korea. On the problem side, Korea is effectively "between two posts" in the climate negotiations. This difficulty has been partly resolved by joining up with two other "orphans" in that process (Mexico and Switzerland), to form the Environmental Integrity Group. Korea also has observer status in the Annex 1 Expert Group. On the opportunity side, Korea has the capacity to serve as a bridge between the older OECD countries and the developing countries. In apparent recognition of this possibility, Korea organized a seminar in Seoul in September on the links between climate change and development, and is planning a follow-up meeting on the same subject next year.

In the field of climate change my message would therefore be that the sooner Korea feels able to undertake the same type of commitments other OECD countries already make under the Convention/Protocol, the better. In the meantime, however, I would encourage Korea to contribute as much as it can to the opportunities offered by its unique position in the negotiations.

9. Trade

Korea is the 13th largest trading country in the world, with exports and imports accounting for nearly 40% of its GDP. Thus is not surprising that Korea has a strong interest in trade liberalistion. It achieved the status of observer in OECD's Trade Committee almost 10 years ago, in 1992, and has been very active in the negotiations paving the way for the new round of global trade negotiations approved recently in Doha. As the negotiations get underway and intensity of domestic challenges to the pursuit of trade liberalisation increases, the OECD through studies such as Open Markets Matter can help Korea make the case for the benefits of trade liberalisation.

Trade is another area in which Korea has been supportive of OECD's outreach activities. A good example of this was Korea's support in September of a Roundtable held in Vladwastok to discuss Russia's trade policy and regional co-operation in the Far East.

10. Labour, Social Affairs, Education and Health

Korea participates actively in the work on employment and labour, social affairs, education and health. Last year the OECD produced the report "Pushing Ahead with Reform in Korea" which analysed major features of the labour market and social safety net policies. Korea will be one of the first case studies in the cross-country review of "Barriers to Work for Older Workers".

On the education side, the OECD conducted a review of Korean education policy in 1996, with a meeting of OECD's Education Committee held in Korea at the end of that process. Korea is strongly involved in the Indicators of Education Systems Project (INES) and the Programme for International Student Assessment (PISA). The just published PISA results show the Korean education system is among the best OECD performers. Korea is one of the small number of countries that shows that it is possible to achieve high levels of performance with all students, not only the elite. (Barry McGaw will have more to say about this tomorrow morning.) Another illustration of Korean interest in education as well as in the OECD process of policy dialogue is the joint OECD-Korean International Conference on Adult Learning Policies held in Seoul just last week.

The OECD Secretariat is now carrying out a review of the Korean health system at the request of the Korean Ministry for Health and Welfare. It will cover the determinants of the financial crisis in the National Health Insurance system, the adequacy of measures recently taken to restore the financial soundness of the system and the options for the medium- and long-term future. The high value to Korea of such a project is evident.

11. Science, Technology and Industry

In view of the leading role Korea plays in some technology areas (for example, Korea leads the world in the deployment of broadband telecommunications infrastructure), it is not surprising that Korea participates vigorously in the committees of the Science, Technology and Industry Directorate. It posed a conference on the Globalisation of Research and Development and International Technology in 1997 and another on Science and Technology Co-operation for Sustainable Development last year. I should refer again, also, to the Regulatory Reform Review which allowed Korean regulators to perceive the importance of accelerating telecommunications market liberalisation. It led to relaxing foreign ownership constraints for telecommunications operators such as Korea Telecom well ahead of the predetermined schedule and extended the scope of liberalisation in the telecommunications sector.

12. Nuclear Energy

Finally, a word about a sister organization, the Nuclear Energy Agency.

The rapid economic growth of Korea in the past decades owes much to the ambitious nuclear power programme that this country developed to meet its rapidly growing electricity demand. Today sixteen nuclear power units contribute over 40% of total electricity production. A further eight units will be commissioned until 2015. Korea has developed its own nuclear energy industry to meet is needs, but it is also exporting nuclear technology to China. The Korean electricity utility recently signed a co-operation agreement with the Chinese Quinchan nuclear power plant.

At an early stage, Korea realised the benefits which it could draw from international co-operation in the field of nuclear energy. As a matter of fact, Korea joined the OECD Nuclear Energy Agency (NEA) in 1993, three years prior to becoming a member of the Organisation. Today Korea is among the most active members of the NEA in a whole range of activities, from science to safety, economics, technology, waste management, or nuclear law, and an important participant in NEA international nuclear R-D projects. The organisation by Korea of the International Youth Nuclear Congress next year testifies to the role the country plays in caring for the development of future competencies in the field of nuclear energy.

Conclusions

I have shared with you just a few of the many positive examples offered to me by OECD's senior management of the mutual benefits Korea and the OECD have gained through this first five years of Korea's membership in the organisation. Speaking as a senior member of the Secretariat I should also acknowledge the very high quality of the Ambassadors Korea has sent to the OECD and express our gratitude for the understanding and support they have always provided to us. Korea's support has also been demonstrated through its assignment of government officials to work in the OECD as "project managers". We are fortunate to have some 20 of these officials with us at present, four in my Directorate (DAFFE). They help us deepen our understanding of Korea and, in turn, they obtain valuable international experience. Indeed, it is this growing two-way flow of benefits that underlies the overall relationship of Korea with the OECD over the past five years. Already I think I can safely say that the promise that membership held for Korea and for the Organisation is clearly being fulfilled. We will continue to work with Korea as it pursues its reform agenda, a process that should provide a sound basis for long-term growth; and the other Members will continue to learn from Korea and make use of that knowledge as they meet the challenges of the future.

Thank you.

SESSION I

OECD's Contribution to Korea's Economic Policy Formulation

Korea and the OECD: A Partnership for Creating a More Market-Oriented Economy

Randall S. Jones
Head of the Korea/Slovak Republic Desk, Economic Department
OECD

Before addressing the OECD's role in Korea, it may be useful to discuss briefly how the Organisation contributes to the formulation of economic policy. The OECD groups thirty countries that share a commitment to democratic government and a market economy. Given its active relationships with some seventy other countries, as well as with NGOs, the Organisation has a global reach. The OECD plays a prominent role in fostering good governance in public service and corporate activity and promoting effective economic policies in a wide range of areas. Through the studies and research produced by the Organisation's Secretariat, the OECD identifies best practices and helps policymakers to respond appropriately to emerging problems with policies that work. In some cases, the OECD establishes international standards to promote the development of the global economy.

The structure of the OECD mirrors that of a central government, allowing the OECD to advise member countries on a wide range of issues. There are, for example, departments dealing with agriculture, environment and trade. The Directorate for Education, Employment, Labour and Social Affairs covers a wide range of topics as its name suggests. Practically the only components of a national administration that are not found in the OECD are ministries of defence, interior and culture. The Economics Department, of which I am a member, includes a Country Studies Branch with desks covering each of the thirty member countries. A major activity of the Korea Desk has been to prepare an *Economic Survey of Korea* each year beginning in 1998.

It is important to note that the OECD attempts to improve economic policies through peer pressure exerted by its member governments. The Organisation has no power or sanctions to coerce countries to follow its recommendations. In particular, there is no "conditionality" by which the OECD can ensure compliance. The process of peer pressure can be illustrated by the Economic Survey of Korea, which begins as a draft prepared by the Korea Desk. The draft is then discussed at a meeting of the Economic Development and Review Committee (EDRC), which consists of all thirty member countries, as well as the European Commission, the IMF and the WTO. Based on the discussion at the meeting, the report -- particularly the initial chapter containing the assessment and recommendations -- is then revised and submitted a second time to the thirty member countries, including Korea, for approval. Once an agreement is reached -- a process that can be problematic in some cases -- the Survey is published on the authority of the Committee. This process of consensus creates the peer pressure that encourages countries to implement the recommendations. Moreover, the Korean government, having accepted the recommendations for publication, knows that its progress in implementing them will be evaluated in the following Economic Survey of Korea.

The Economic Surveys cover both macroeconomic and microeconomic (or structural) issues. Typically, there is a chapter on recent trends and prospects followed by a chapter on fiscal and monetary policies. On the structural side, each Survey includes an in-depth examination of an important issue. In the case of Korea, we have thus far examined the labour market, the financial sector, tax reform and policies to cope with an ageing population, with a study of public expenditures planned for the next Survey. In addition, there is a "structural surveillance" chapter that covers a wide range of issues. In the case of Korea, these chapters have analysed such topics as competition policies, corporate governance, the chaebol, small and medium-sized enterprises, trade and foreign direct investment policies, regulatory reform and land use. In addition, specific sectors, notably agriculture, electricity and telecommunications, have been discussed, along with policies aimed at creating a knowledge-based economy.

To cover such a wide range of topics in the Economic Survey, the Korea Desk draws on the work done by specialists in other parts of the OECD. During the past few years, other departments have also published reports on Korea. In particular, the department concerned with labour issues published a study on labour market and social safety net policies in 2000,[1] while another directorate completed a report on regulatory reform.[2] In addition, the OECD department dealing with science and technology issues produced, in co-operation with the World Bank, a study on policies to promote a knowledge-based economy.[3] Finally, a report on regional policies has just been published.[4]

The first section of this paper will review the OECD's contributions to Korea's economic policies, both macroeconomic and structural. It will be followed by a discussion of future directions for the Korean economy. The final section will briefly consider Korea's role in the OECD.

I. The OECD's contribution to Korea's economic policy formulation

A. Macroeconomic policies

Recommendations for the setting of monetary and fiscal policy are only as good as the economic forecasts on which they are based. Twice a year, the OECD Economics Department produces projections over a two-year time horizon, which are published in the OECD Economic Outlook. To be precise, these are conditional forecasts based on unchanged nominal exchange rates and announced fiscal policies. The OECD projections are unique in that they are consistent at the world level -- in other words, the growth of world exports and world imports have to be

1 *Pushing Ahead with Reform in Korea; Labour market and social safety-net policies*, (OECD, 2000).

2 *Regulatory Reform in Korea*, (OECD 2000).

3 *Korea and the Knowledge-based Economy: Making the transition*, (OECD and the World Bank, 2000).

4 *Territorial Review of Korea*, (OECD, 2001).

equal to each other.[5] The projection for Korea, where exports account for almost half of economic output, depends heavily on the projections made by other country experts, especially those for the United States. Indeed, Korean exports to the United States accounted for 10 per cent of Korea's GDP in 2000.

While OECD projections are internationally consistent, they are not always right. In the spring 2001 edition of the Economic Outlook, for example, we expected Korea to begin an economic recovery in the second half of this year, led by a favourable external environment. This projection was based on growth in Korean export markets at nearly 8 per cent in volume terms in 2001, leading to an 11 per cent rise in exports and a 4 per cent rate of economic growth. Of course, this projection was well off the mark, primarily as a result of developments in the ICT sector and the September terrorist attacks in the United States. The projections released a few weeks ago[6] show a much different picture for this year: demand in Korea's export markets is expected to have declined in 2001, leading to a small 1½ per cent gain in export volume and a 2 per cent rise in output. With the US economy not projected to pick up until the second half of 2002, a rebound in the Korean economy may not occur until mid-2002 (Figure 1). Consequently, economic growth may be limited to 3 to 4 per cent next year, before returning to its potential rate of 5 to 6 per cent in 2003 (Figure 2).

Having given an example of where our projections were off the mark, let me offer two counter-examples where we were able to provide useful macroeconomic policy advice based on our economic projections. In March 1998, at our bi-annual meeting with economic forecasters from national governments to discuss the OECD's preliminary projections, the Korean government's official forecast was still for 1 per cent growth in 1998. The Korea Desk, on the other hand, projected a recession. Of course, the decline in output turned out to be much more severe than we had anticipated in March -- nearly 7 per cent in 1998 -- but at least we had the sign right. Based on this projection, the Korea Desk recommended that macroeconomic policies, including fiscal policy, be used to limit the depth of the recession. However, the Korean government, which was under the IMF programme at the time, was committed to balancing its budget in 1998. Indeed, it introduced tax increases to boost revenue by 1 per cent of GDP at the same time that the economy was falling into its worst recession since the Korean War.[7] The OECD recommendation contributed to the shift in fiscal policy that began by mid-1998 and resulted in a substantial rise in outlays, particularly to assist the large number of newly-unemployed persons.

A second interesting example occurred in 2000, when the economy was growing strongly and there were concerns about inflationary pressure, leading some to call for the Bank of Korea to tighten monetary policy. Higher interest rates, though, would have complicated the restructuring of heavily-indebted companies, with negative implications for the banking sector. To counter any signs of overheating, the 2000 *Survey of Korea* recommended, instead, that fiscal consolidation be speeded up and that the won be allowed to appreciate, even at the expense of a smaller current

---

5 International trade statistics report a significant discrepancy between world exports and world imports. In making projections, this gap should remain broadly constant.

6 *OECD Economic Outlook*, Volume 2001/2, No. 70 (November).

7 This is discussed in Chapter I of the 1998 *OECD Economic Survey of Korea*.

account surplus.[8] This policy mix, in fact, was implemented and helped to sustain the expansion until it was derailed by the drop in demand for ICT products at the end of 2000.

B.Structural policies

Structural policies have been a very high priority in Korea. In contrast to Latin American countries, which experienced foreign-exchange crises largely as a result of fiscal and monetary policy mistakes, the 1997 crisis in Korea was primarily due to problems in the corporate and financial sectors. Indeed, a Ministry of Finance and Economy publication in 1999 stated:

Development of a market economy was seriously hindered, as the government became increasingly bloated and unresponsive to demands for reform. The economy was hampered by collusive ties between government and businesses, arbitrary regulations and corruption..Over the past thirty years of accelerated economic growth, former governments were deficient in developing the rules and principles of a market economy, failing to implement structural reform policies consistent with the changes in the international environment. 9

A primary objective of the OECD has been to assist in the development of institutions, rules and principles in Korea that are necessary for a market economy. This section will review the OECD's role in the reform of the corporate and financial sectors, the labour market and in regulatory reform.

1. The corporate sector: corporate governance, competition and the chaebol

The corporate sector was at the heart of the 1997 crisis as well as the reforms adopted in its wake.[10] The chaebol-based model of wide diversification into capital-intensive industries through debt-financed investment, which had produced rapid growth in the 1970s and 1980s, proved to be ill-suited for a more integrated global market in the 1990s. By the end of 1997, a surge in investment to boost capacity had raised the debt to equity ratio for the thirty largest chaebol to 519 per cent, imposing onerous debt service costs on corporate cash-flow. Indeed, such costs accounted for 17 per cent of total business costs. By mid-1997, rising financial costs exceeded operating profits, which were subdued by slower growth and the decline in the terms of trade. This contributed to a 50 per cent jump in the number of bankruptcies in 1997, including seven of the thirty largest chaebol. A number of factors, including a weak corporate governance framework, lack of competition in product markets, moral hazard problems that led to excessive risk-taking and the weakness of the financial sector, were responsible for the problems in the corporate sector.

The Economic Surveys of Korea since 1998 have placed great emphasis on improving the corporate governance framework and improving transparency. A number of measures have been taken in line with these recommendations to strengthen shareholder rights, expand the role of boards of directors, introduce outside directors, allow cumulative voting, improve accounting

8 Please see the Assessment and recommendations of the 2000 *OECD Economic Survey of Korea* for further details.

9 *DJnomics: A new foundation for the Korean economy*, Ministry of Finance and Economy (1999).

10 For more details on the origins of the crisis, please see Chapter I of the 1999 *OECD Economic Survey of Korea*.

standards and permit the creation of holding companies (Figure 3). Other improvements to the corporate governance framework were included in a "Code of Best Practices", which was introduced in September 1999. The Korea Stock Exchange requires listed companies to disclose to what extent they meet these practices.

Other reforms have boosted competition through reducing trade restrictions, encouraging foreign direct investment and strengthening competition policy. Perhaps the most important measure was the elimination of the Import Diversification Programme, which had restricted imports of certain items from Japan in an effort to reduce the bilateral trade deficit. At its peak, as many as 924 items were restricted. The government also actively encouraged inflows of foreign direct investment, which had played a relatively minor role in Korea's economic development prior to the crisis, and reduced remaining legal restrictions. Consequently, the stock of foreign direct investment in Korea doubled between 1997 and 1999. At the same time, the Korea Fair Trade Commission has been enlarged to strengthen competition policy. The number of orders or sanctions imposed by the KFTC increased by 57 per cent between 1996 and 1999. The 1999 Omnibus Cartel Repeal Act, which eliminated statutory authority for 17 cartels, also had a positive impact. A survey by the KFTC reported a significant decline in the prices charged in these sectors since 1999.[11]

The new framework introduced following the crisis appear to have contributed to considerable changes in the chaebol and may mark a turning point in their behaviour.[12] Of the top thirty groups in 1997, only 18 remained on the list in 2001. Five of the new groups were previously part of Hyundai, the largest chaebol until 2000.[13] The break-up of Hyundai appears to be representative of more independent behaviour by chaebol-affiliated companies, who appear to focus more on their own profitability and less on the interests of the group. This may reflect the impact of the new corporate governance framework. Indeed, one chaebol affiliate explained its decision not to assist a sister company by saying that it feared it would be sued by its shareholders if it took such an action. The average number of affiliates of the top thirty groups fell by a third between 1997 and 2000 (Figure 4), as the chaebol sold assets to reduce debt. Meanwhile, the average number of business lines declined from 19 to 15 over the same period.[14] The average number of affiliates, though, rose in 2001, largely as a result of an increased number of information technology-related firms. However, the new chaebol-affiliated companies appear to be relatively small; the average amount of assets per firm fell 10 per cent in 2001. Total assets fell between 1999 and 2001, reversing the large increases that occurred in the wake of the crisis (Panel B). To achieve the 200 per cent debt to equity target imposed by the government, the chaebol issued large amounts of new equity. Indeed, the ratio, which was 519 per cent in 1997, fell to 219 per cent at the end of 1999 and 171 per cent at the end of 2000 for the top thirty groups, excluding their financial affiliates. The decline in the ratio, however, was largely a result of the increase in equity rather than a decline in debt, leaving financial costs at a high level.

11 For details, please see Chapter V of the 2001 *OECD Economic Survey of Korea*.

12 This issue is examined in Chapter IV of the 2001 *OECD Economic Survey of Korea*.

13 Hyundai will continue to evolve with the separation of the heavy industry and shipbuilding activities at the end of 2001. The retirement of the founder, Chung Ju-Young, from Hyundai's activities in 1999 was a factor in its separation into a number of groups, some of which are led by his sons.

14 It should be noted that part of the decline in 2000 was due to the division of Hyundai into three groups among the top thirty and the demise of Daewoo, with 34 affiliated companies.

Reductions in financial costs, at least relative to 1998, were accompanied by lower labour costs, reflecting an increased emphasis on profitability. The number of workers at listed firms affiliated with the chaebol declined by 30 per cent between 1996 and 1999, compared to a 6 per cent fall at independent companies. Consequently, labour costs fell from 12 to 8 per cent of total costs over the same period (Figure 4, Panel C). Cost reductions, in turn, improved profitability; the percentage of firms with interest coverage ratios of less than one fell to 44 per cent for the chaebol-affiliated companies and to 29 per cent of independent companies (Panel D). Finally, the increase in equity in 1998 and 1999 boosted the proportion of the top thirty chaebol that is owned by their affiliated companies. Consequently, the "inside ownership ratio" surpassed 50 per cent in 1999, despite the continued decline in the share of the principal owner and family. The re-imposition of the rule in April 2000 prohibiting chaebol-affiliated firms from owning more than 25 per cent of another firm has reversed the rise in shareholding by sister companies. That share is likely to decline further as firms try to meet the 25 per cent limit by the March 2002 deadline for compliance. In summary, there have been some significant changes in the chaebol, which suggest that the new framework has had an important impact on their behaviour.

2. The financial sector

The problems of the financial sector have been inextricably linked to those in the corporate sector, both leading up to the crisis and in the four years since then. The sharp rise in corporate debt and bankruptcies in 1997 resulted in a surge in non-performing loans that undermined the balance sheets of banks. In the wake of the crisis, the Korean authorities faced the double challenge of maintaining a functioning financial system and, at the same time, laying the groundwork for a more market-oriented system.[15]

The establishment of a market-oriented financial system required the closure of nonviable institutions. This was a major event in Korea, which had never experienced the failure of a financial institution prior to the crisis. Since the crisis, though, the number of commercial banks has fallen from 26 to 17, while all but nine of the thirty merchant banks have disappeared (Figure 5). Overall, the number of financial institutions fell by a fifth.

A market-oriented financial system also required an upgrading of prudential standards in line with the norms in OECD countries. To improve the supervisory framework, the Financial Supervisory Commission, an independent and unified body covering banking, insurance, non-banks and the capital market, was established (Figure 5, Panel B). Key elements included a prompt corrective action framework to deal with financial institutions failing to meet prudential standards and a forward-looking loan classification system.

In addition to bringing the supervisory framework into line with international standards, the OECD recommended prompt action to address the problems of non-performing loans and the under-capitalisation of financial institutions. Such measures were necessary to maintain a functioning financial system and allow the economy to recover from the crisis. While these problems are expensive to resolve, a substantial portion of the initial outlays can be recovered if the restructuring process is skilfully managed. As of March 2001 (Figure 6), the government spent

15 The restructuring of the financial sector is discussed in detail in Chapter III of the 1999 *OECD Economic Survey of Korea*.

a total of 135 trillion (25 per cent of GDP). Almost two-thirds was used to rehabilitate the banking system, while the remainder was primarily spent on investment trusts, merchant banks and insurance companies. The Korea Asset Management Corporation (KAMCO) has purchased around 100 trillion won of impaired assets since the crisis. Additional funds were used by the Korea Deposit Insurance Corporation to re-capitalise weak financial institutions and reimburse depositors. Additional expenditures under the second-stage financial-sector restructuring programme (Panel B) brought total outlays to 150 trillion won by October 2000. Of this amount, about a quarter had been recovered, primarily through the sale of bad assets.

Despite the strong recovery, the banking sector as a whole recorded large losses in 1999 and 2000 due to provisioning against further increases in non-performing loans (Figure 7). This was partly a result, though, of the introduction of a "forward-looking" loan classification system at the end of 1999. This change seems to have encouraged banks to become more risk-conscious, causing them to reduce their exposure to large companies while increasing lending to households. At the same time, the non-bank financial sector has shrunk considerably during the past few years, reflecting the closure of many institutions. This in turn contributed to a sharp decline in the corporate bond market, where these institutions had been major players.

While there are many remaining problems, the efforts to restructure the financial sector have resulted in a group of privately-owned, well-managed banks with strong balance sheets that are earning profits. The non-performing loans of these banks have been reduced from 5.5 per cent of total loans in 1999 to 4 per cent in 2000. These banks meet tough prudential standards and have gained the confidence of international capital markets, in part because they have only a limited exposure to the chaebol. Moreover, these banks have a significant degree of foreign participation.

3.The labour market and social welfare

The degree of labour market flexibility has been a concern in Korea. At the time of the crisis, it was virtually impossible for firms to resort to mass layoffs, and the OECD argued that this limited the ability of the corporate sector to respond to structural changes. Indeed, the OECD's *Employment Outlook* ranked protection for regular workers in Korea as the second strictest in the OECD area. In February 1998, though, the labour law was revised to allow firms to reduce employment for "urgent managerial reasons", including mergers and acquisitions. However, new conditions were imposed on companies wishing to resort to layoffs, including a requirement that they have sixty days of discussion with workers' representatives and notify the Ministry of Labour in the case of large layoffs.[16] There have been signs that, despite these conditions, labour market flexibility has been increased. One example is the commercial banking sector, which recorded a 39 per cent drop in employment between 1997 and mid-2001.

The OECD has also argued that increased flexibility in the labour market should be accompanied by an enhanced social safety net. There has also been progress in this regard, notably the expanded coverage of the Employment Insurance System. At the time of the crisis,

16 The thresholds for reporting layoffs are:
More than ten regular workers in a firm with less than 100 employees.
More than 10 per cent of regular workers in a firm with 100 to 999 employees.
More than 100 regular workers in a firm with more than 1 000 workers.

unemployment insurance was limited to firms with more than thirty employees, or about a third of all employees. At present, coverage has been extended to about three-fourths of all employees, leaving only some part-time and daily workers, elderly employees and government workers outside the system. In addition, the government also sharply increased vocational training and public works jobs in response to the sharp rise in unemployment in the wake of the crisis (Figure 8). Indeed, spending on labour market policies, including income support, jumped from less than 1 trillion won (0.2 per cent of GDP) in 1997 to 15.7 trillion won (2.7 per cent in 1999). Finally, the government introduced the "productive welfare" system in October 2000, which makes social assistance a right for those who qualify under the eligibility criteria and ensures that recipients' income reaches the minimum cost of living.[17]

4.Regulatory reform

The OECD Report on Regulatory Reform in 1997 recognised that regulation has imposed significant burdens in many member countries. This report stressed the importance of improving regulation in order to increase transparency, reduce the administrative burden on the private sector and enhance product market competition. The Korean government has also acknowledged that "numerous and unnecessary regulations have undermined national competitiveness and become the cause of corruption and misconduct".18

In the wake of the 1997 crisis, Korea made regulatory reform a top priority. Beginning in April 1998, one-half of the existing 11 125 regulations were eliminated over a one-year period (Figure 9), while another 1700 informal regulations were abolished.[19] Reform was guided by five principles:

1. Eliminate, in principle, all anti-competitive economic regulations;
2. Improve the efficiency of social regulations in such areas as the environment and health;
3. Shift from *ex ante* control to *ex post* regulation;
4. Base all regulations on adequate legal authority;
5. Benchmark global standards.

Implementing reforms is not a simple process, as it requires changing the mindset of civil servants that have been responsible for implementing interventionist policies. Moreover, it is difficult to determine the precise benefits of this item-by-item approach. Nevertheless, eliminating half of existing regulations in such a short time frame could not help but have a real impact on the role of the government in the economy. Indeed, two recent developments suggest that an improvement in the regulatory environment did, in fact, take place. First, inflows of foreign direct investment have jumped from less than $2 billion prior to the crisis to more than $15 billion in

17 Please see Chapter II of the 2000 *OECD Economic Survey of Korea* for more details.

18 Office of the Prime Minister, *The Basic Act on Administrative Regulations* (1999).

19 The regulatory reform programme is described in more detail in Chapter IV of the 2000 *OECD Economic Survey of Korea*.

both 1999 and 2000 (Figure 10). Second, the average number of firms created each month in the largest cities has doubled from around 1 750 in 1997 to 3 455 in 2000. To give one concrete example, the establishment of a foreign-exchange business, which used to require prior permission, now only needs registration. Consequently, the number of such businesses almost doubled from less than 600 in 1999 to 1 138 in March 2001.

II. Policy directions for the future

Korea's rapid economic growth, which averaged 7½ per cent between 1970 and 1997, substantially narrowed the income gap with other OECD countries, which recorded a much lower growth rate of less than 3 per cent on average. Consequently, Korea's average income per capita, measured on a purchasing power parity basis, converged from less than one-fifth of the OECD average to almost two-thirds over that period. Relative to the United States, Korea's average income per capita rose by a factor of four from 13 to 50 per cent. The fundamental question is what policies will ensure that this process of convergence with other OECD countries continues.

At the same time that Korea is converging with the most advanced countries in the OECD, less-developed countries are converging on Korea and aiming to increase its market share by charging low prices. One principal competitor in this regard is China, which in the local press is sometimes portrayed as a threat to the Korean economy. Indeed, China does have some factors, notably a relatively low wage rate, which may appear to give it some competitive advantages. However, China is also characterised by a weak banking system that is largely state controlled and encumbered by non-performing loans, a lack of labour market flexibility to facilitate industrial restructuring and the absence of a good corporate governance framework. These were key problems in pre-crisis Korea and the focus of the reform efforts over the past five years. Effectively implementing these reforms would leave Korea with little to fear from China, which instead appears to be a major economic opportunity, particularly with China's entry into the WTO. This section addresses the direction of reform necessary to sustain Korea's convergence to the high-income OECD countries, while limiting its vulnerability to crisis.

A. Improving the implementation of fiscal and monetary policy

In addition to recommendations about the stance of fiscal and monetary policy, the Economic Surveys of Korea have emphasised measures to improve the effectiveness of these policies. In addition to efficiency concerns, these policies are important to maintain stability. The importance of the ICT sector, which now accounts for a third of Korean exports, has made the economy increasingly vulnerable to external shocks. Indeed, the volatility in the prices and demand for such products as semiconductors has had a significant influence on the Korean economy since the mid-1990s. Effective macroeconomic policies have an important role to play in attenuating such fluctuations.

1. Fiscal policy

There are a number of glaring weaknesses in government expenditure practices that make it difficult to operate a coherent fiscal policy. The budget has a complicated structure, consisting of a general account and 23 special accounts that are subject to legislative approval, plus 43 public funds, which only require cabinet approval and allow the responsible ministry considerable discretion. Such a structure has a number of disadvantages.[20] *First*, expenditures on a consolidated basis are unknown when the budget is passed, thus reducing transparency and making it difficult to monitor fiscal policy, which targets the consolidated budget balance. *Second*, relying on public funds tends to blur the distinction between the public and private sectors. *Third*, the compartmentalisation of spending reduces allocative efficiency by hindering the transfer of funds to their most productive use. It is very important, therefore, that all public funds -- as well as extra-budgetary funds that are not even included in the consolidated budget -- are integrated into the budget submitted to the National Assembly. *Fourth*, the government does not calculate a "general government balance", which is the focus of fiscal policy in most other OECD countries. These issues will be highlighted in the special structural chapter on public expenditures in the next *Survey*.

In addition to increasing transparency and efficiency, maintaining a sound fiscal policy should be a priority. Prior to the crisis, Korea's central government debt was relatively low at 8 per cent of GDP (Figure 11). By 2000, though, it had reached 20 per cent. In addition, local government debt and government-guaranteed borrowing, particularly for financial-sector restructuring, boosted the government's obligations to about 38 per cent of GDP. Given the fiscal implications of Korea's rapidly-ageing population and the uncertainty about the costs of economic integration with North Korea, it is essential to maintain a healthy government financial position. In this regard, the "Fiscal Responsibility Law", which was introduced into the National Assembly earlier this year but never passed, would be helpful. This law would require the government to provide a three-year fiscal plan on an annual basis and prohibit the use of supplementary budgets except in case of a crisis. Moreover, any proposals to boost spending or cut revenues would have to provide a plan to offset the impact on the budget. The proposed law would also require the budget to provide information on contingent liabilities and quasi-fiscal activities, such as government guarantees on private-sector loans and bonds.

On the revenue side, there are a number of aspects of the tax system that undermine tax bases, efficiency and the fairness of the system.21 These include generous allowances and loopholes for individuals, large-scale and wide-ranging tax preferences for enterprises and an inappropriate taxation of property. Moreover, there is a lack of strong and uniform tax enforcement, especially toward the self-employed. With the tax burden in Korea currently one of the lowest in the OECD area (Figure 12), the economic distortions created by the tax system are relatively limited, especially with respect to the labour market. However, the tax burden is likely to rise in the future, making it important to minimise existing tax-related distortions in order to avoid magnifying their negative effect. One problem affecting fairness in the tax system -- the treatment of pension savings -- was recently resolved by the introduction of a so-called EET system, which exempts contributions and interest earnings.[22]

---

20 This topic is analysed in Chapter II of the 2001 *OECD Economic Survey of Korea*.

21 Tax reform was the special topic in the 2000 *OECD Economic Survey of Korea*.

22 In the previous system, pension contributions were partially taxed. In a recently implemented and partially-funded system like Korea's, the timing of taxation has important implications for revenues and inter-generational equity (please see Box 8 in the 2000 *OECD Economic Survey of Korea* for details).

2.Monetary policy

The conduct of monetary policy has changed considerably since the 1997 foreign-exchange crisis. The Bank of Korea was made independent in 1998 and given responsibility for setting and achieving an annual inflation target. In addition, the central bank shifted in 2001 from its long-time practice of targeting the growth of monetary aggregates in favour of an interest rate-based policy. The *Surveys of Korea* have recommended a number of additional changes to improve the conduct of monetary policy:

1. Public comments by government officials concerning interest-rate policy in the first few years after the independence of the central bank tended to confuse market participants about the Bank of Korea's operational independence and should be avoided.

2. The intended shift to an interest rate-based approach is complicated by the continued use of "aggregate credit ceiling loans" aimed at encouraging bank lending to small and medium-sized enterprises. Moreover, the rationale for such assistance has been greatly weakened since the access of SMEs to bank loans appears to have been enhanced during the past few years.

3. The central bank should change its practice of setting an annual inflation target each December for the following year in consultation with the government and instead focus on its medium-term target. Given the long and unpredictable transmission mechanism of monetary policy changes on the economy and on the rate of inflation, setting an annual inflation target does not appear to be appropriate.

B. The corporate sector

The key priority is to complete the shift to a market-based system in which pressures from shareholders and creditors, competition and the threat of bankruptcy discipline corporate behaviour, thus reducing the need for government intervention. As noted above, the government has played an active, and at times, heavy-handed role in Korea's development. In the wake of the crisis, the authorities established the objective of creating a more market-oriented framework. In these difficult conditions, however, the government played an even more active role in some respects. This reflected the fact that markets had ceased to function effectively, thus creating a need for government intervention. Consequently, we had the paradox of the government using interventionist policies at the same time that it was trying to create a market-oriented economy. One example was the "Big Deals", which was strongly criticised in the 1999 *OECD Economic Survey of Korea*. A second example was the across-the-board 200 per cent debt to equity target imposed by the government. While reducing debt was clearly appropriate, the imposition by the government of a uniform target, regardless of the nature of the company or its line of business, was hard to justify.[23]

The difficulty of shifting to a reliance on market forces can be illustrated by policies toward the chaebol. One of the key objectives of competition policy in Korea is to establish an

23 The Big Deals and the 200 per cent debt to equity target are discussed in Chapter IV of the 1999 *Economic Survey of Korea*.

environment in which the chaebol compete on equal terms with other firms. Rather than focusing on anti-competitive practices, direct regulation to shape the market structure has been used. In particular, the KFTC has had the power since 1988 to regulate aspects of the business groups' corporate and investment structures. For example, direct cross shareholding between companies belonging to the same chaebol are prohibited and total equity investments in other companies are limited to 25 per cent of the net assets of the investing company. Moreover, new mutual loan guarantees were prohibited in 1998 and all outstanding guarantees were ended by March 2000. In addition, the law requires that transactions between companies in the same business group be on the same terms as those between unaffiliated companies in order to prevent the subsidisation of weak companies by their sister firms. The KFTC was given special power in 1999 to investigate the bank accounts of affiliates of the top thirty chaebol in order to search for evidence of illegal intra-group transactions.[24]

The regulation of corporate investment and financial structures failed to prevent the chaebol-related problems that played a role in the 1997 crisis. Moreover, such regulation is unique in the competition laws of OECD member countries. Measures that had the effect of preventing diversification of chaebol seemed to run counter to the traditional competition policy objective of limiting market concentration. Moreover, the concerns about the chaebol appear to have more to do with corporate governance and prudential supervision of financial institutions than with competition policy. In the wake of the crisis, there have been considerable efforts to improve the corporate governance framework as noted above. At the same time, financial supervision has been revamped with the establishment of the FSC. However, such institutional improvements have just begun and are still underway. It will take time before such changes are fully reflected in practice. Therefore, the government should continue reform efforts until the institutional improvements lead to clear changes in practices, including internal and external monitoring mechanisms for corporate behaviour. The competition authority has an important role to play in strengthening competitive forces, which are one of the most powerful factors disciplining corporate performance. The KFTC's mixing of competition policy goals with the emphasis on monitoring and supervision of chaebol, however, may reduce the resources available for more traditional competition policy concerns. In addition, the new mechanisms and institutions should be given a chance to prove their effectiveness. In summary, as these institutions and mechanisms develop, the KFTC should shift its emphasis to the efficiency-related concerns that are the focus of competition authorities in other OECD countries, which require significant investigative and analytical capacity. The plan to limit the regulation of chaebol to those above a certain size (assets of more than 5 trillion won) rather than arbitrarily to cover the thirty largest chaebol is a positive development.

Another concern is the use of government guarantees for private-sector companies.[25] The bunching of maturities in 2001 and the lack of a functioning market for low-rated debt created a risk that a large number of major firms would go bankrupt over a short period of time, thus risking a systemic crisis in the financial system. To prevent such an outcome, the government launched "collateralised bond obligations" (CBOs) in 2000 to roll over maturing corporate bonds using partial government guarantees. This approach continued in 2001, supplemented by a bond-underwriting scheme run by the Korea Development Bank (KDB), a public institution, for seven

24 This authority, originally granted for two years, was recently extended to 2004.

25 Government guarantees and bankruptcy procedures are discussed in all of the *OECD Economic Surveys of Korea*, including Chapter IV of the 2001 edition.

large companies, including five Hyundai-affiliated firms. However, the reliance on a public institution and government guarantees to roll over the bonds of weak companies risks blunting the role of market forces in corporate restructuring, creating moral hazard problems and giving the impression that some firms are still too big to fail. The 1999 failure of Daewoo, then the second largest chaebol, suggested that no firm was too big to fail. However, the numerous rescue packages -- involving government-owned financial institutions -- extended to companies such as Hyundai Engineering & Construction and Hynix appear to suggest that "too big to fail" is still in effect. To limit the negative consequences of government guarantees, it is important that they be restricted to firms facing only temporary liquidity problems. It is also essential to ensure transparency about the liabilities assumed and the potential cost to taxpayers. Finally, the participation of financial institutions in these schemes should be entirely voluntary. While the KDB scheme is ending this year, the CBO scheme should also be phased out to allow market forces to drive restructuring.

A key component of market-based restructuring is an effective exit mechanism. This is a key consideration in Korea, given the large number of financially weak firms (Figure 13). Even in 2000, when economic growth was nearly 9 per cent, a quarter of firms audited externally did not earn enough profits to pay even the interest cost on their debt, let alone repay principal (Panel B). There is a risk that such enterprises absorb resources that could finance more productive firms, while eroding profit margins for healthy companies. In addition to acting as a drag on the economy, these firms have the capacity to destabilise the economy. In October 2000, the government instructed banks to review the status of 287 weak companies, repeating the screening process undertaken in June 1998. This led to the designation of 29 companies for court receivership or liquidation. However, the number of firms screened and chosen for bankruptcy procedures is small relative to the 563 firms identified as not having earned enough profits to cover interest payments for at least three consecutive years. Moreover, the screening of firms by financial institutions should not occur at thirty-month intervals, but instead should take place on a more regular basis and without government prompting. Legal bankruptcy procedures should be improved further, in part by the introduction of a "pre-packaged" bankruptcy system that limits the duration of legal procedures and gives creditors a larger role. In addition, workout programmes, which have consisted primarily of concessions on debt, should focus more on operational restructuring. Corporate restructuring vehicles, allowed since October 2000, could play a useful role in this regard.

While Korea has made impressive progress in changing the laws, institutions and procedures that are necessary for a well-functioning market economy, it will take time to change the structure of the Korean economy. Indeed, effective implementation of this framework requires additional human capital and changes in the behaviour of economic agents. This situation is sometimes illustrated by the analogy that Korea has changed the hardware but now faces the more difficult task of changing the software. This is particularly true in the area of corporate governance. The entrenched power of the principal owners of the chaebol as well as Korean business traditions complicate the task of activating the new governance framework. While the commercial code has been changed to require that outside directors make up a quarter of corporate boards, there are doubts as to their independence and influence. According to a study by the Korea Stock Exchange at the end of 2000, outside directors supported management in 99.3 per cent of their key decisions. About 80 per cent of outside directors were nominated by management or the main shareholder -- typically the family of the chaebol founder. The use of cumulative voting, one means of allowing minority shareholders a greater voice in the selection of directors, should be encouraged by the stock exchange as a good corporate governance practice.

Another concern is that there have only been a handful of derivative suits despite numerous actions within chaebol affiliates that are harmful to shareholders.[26] One option that has been under careful consideration, but firmly opposed by some, is class action suits, which have the attractive aspect of providing benefits directly to shareholders. If the class action approach is rejected, alternative measures to encourage action by shareholders damaged by management misconduct should be considered. For example, the commercial code could be amended to allow shareholders who prevail in court to receive a portion of the damages payable to the company to compensate them for the costs of managing litigation.

Finally, improved corporate governance requires enhanced transparency. Accounting standards were raised following the crisis, but government supervisors have found that a third of surveyed companies have violated the rules. One weakness is that the number of qualified accountants, which total about 4 000, is low relative to the more than 8 000 firms that are required to have external audits of their financial statements, generally at the same time of year.

C. Financial sector

The development of a sound, market-based financial system is essential to advance the restructuring of the corporate sector. This is particularly important as the problems in the corporate sector are inextricably intertwined with those in the financial sector. Indeed, it is clear that the financial system cannot be put on a sound footing as long as the degree of credit risk and instability in the corporate sector remain high. The large exposure to troubled firms poses serious risks to banks' balance sheets. Looking ahead, financial institutions should further improve credit-risk assessment and lending practices and take an aggressive stance on asset quality to promote the restructuring of the corporate sector. Successfully completing the second-stage financial-sector restructuring programmes, so as to avoid a need for further programmes, should be a priority. Moreover, it will increase the amount of public outlays that can be recovered. The Korea Asset Management Corporation has had impressive success in this regard in selling non-performing loans acquired from financial institutions and this should continue.

A major concern is the number of remaining weak banks (Figure 6). In contrast to the stronger banks, these institutions are largely government-owned and have large exposures to the chaebol. The supervisory authorities should ensure that the "forward-looking" loan classification system is effectively implemented, which should help to expedite corporate restructuring. It is important that the financial holding company, which began operations in April 2001 with four weak banks, have managerial independence and achieve profitability in order to avoid additional injections of public funds. This is likely to require the closure of overlapping capacity. In the non-bank sector, there are number of concerns in the insurance companies and in the investment trust companies, which have contributed to a serious problem of solvency in the corporate bond market.

26 This may reflect a problem of free riders since the benefits in successful cases go to the company and are enjoyed by all shareholders, not just those initiating the suit. Moreover, the shareholders who bring derivative suits bear the legal costs.

Most importantly, the privatisation of commercial banks should be a priority. As a result of capital injections since 1998, the government now owns a third of the commercial banks. In terms of the banking sector's capital, 62.5 per cent was is in the hands of the government in June 2001, possibly posing an obstacle to bank-led restructuring of the corporate sector. At the very least, it puts the government in the centre of difficult restructuring cases, such as Hynix. Indeed, the top four creditor banks for Hynix are government-owned.[27] Selling the government's ownership position will reduce the authorities' influence, implicit or explicit, and place difficult questions of corporate restructuring squarely in the hands of the private sector. At present, the share prices of banks are depressed, suggesting that delaying privatisation may increase the portion of the public funds that can be recovered. However, the cost of delaying bank-led restructuring of the corporate sector outweighs this potential benefit.

D. The labour market and the social safety net

There are several concerns related to the labour market. According to official statistics, only 29.7 per cent of the labour force and 47.6 per cent of employees were classified as "regular workers" in 2000.[28] The official statistics imply a degree of employment flexibility but also job precariousness that is the highest in the OECD area, where regular workers account for an average of 71 per cent of the labour force and 87 per cent of employees. However, a recent study found that the degree of job precariousness may be less than implied by the statistics since a significant number of temporary workers remain at the same firm on a semi-permanent basis.[29] While there is a need for further research into this issue of regular versus non-regular workers, a few points appear clear. First, the proportion of non-regular workers has probably risen during the past few years, as suggested by the increase in the monthly labour turnover rate from 4.5 per cent in 1998 to 5.6 per cent in 2000. This may contribute to the relatively short average tenure of workers in Korea relative to other OECD countries. Second, non-regular workers are attractive to firms because employees with less than one year of employment do not qualify for the retirement allowance and those with less than six months are not covered by the Employment Insurance System. Third, additional flexibility regarding regular workers may be beneficial. The implications for economic efficiency and equity of a dualistic labour structure consisting of well-protected regular workers and a growing share of non-regular workers -- if this is indeed the case -- need to be examined.

A second concern is the adequacy of the social safety net. One striking figure is that the proportion of unemployed persons receiving unemployment benefits fell from 13.5 per cent in 1999 to 11.3 per cent in 2000. This decline came despite the fact that coverage of unemployment insurance has increased to almost half of those in the labour force. One explanation is that the

---

27 Korea Development Bank, Korea Exchange Bank, Hanvit Bank and Chohung Bank. In addition, Seoulbank has a large exposure to Hynix.

28 Under Korean definitions, regular workers are those who work more than one year at a firm and are paid standard wages, plus bonuses and overtime. Non-regular workers, 52.4 per cent of employees in 2000, are those who work for a determined length of time, such as temporary workers and daily workers. These issues are discussed in detail in the OECD report, *Pushing Ahead with Reform in Korea: Labour Market and Social Safety-Net Policies*, (2000).

29 A recent study estimated the number of non-regular workers at 18 per cent of employees. See Kyungsoo Choi (2000), "An international comparison of the number of non-regular workers" in *Korea Labour Economic Association's 2001 Seminar*, (in Korean).

duration of benefits is limited to between three and eight months, thus excluding the long-term unemployed. In 2000, 13 per cent of the unemployed had been out of work for more than six months. Another reason is that the strict eligibility requirements based on age and the number of years of contribution limit the number of recipients. However, with the Employment Insurance System now nearly seven years old, its coverage should be increasing. This raises concerns about the degree of compliance of firms with the Employment Insurance System. As noted above, an inadequate social safety net will tend to strengthen the opposition of workers to structural change, which is inevitable in a rapidly growing economy like Korea. Finally, it is uncertain whether the new productive welfare system will adequately provide for those in need, given the strict income and asset tests imposed.

A third concern is the confrontational attitude of the social partners. In some cases, such as with Daewoo Motors, this has complicated and hindered the necessary restructuring. To some extent, the conflicts between management and workers may reflect problems of immaturity less than fifteen years after the democratisation of Korea. There have been important steps in bringing Korea's industrial relations framework into line with internationally-accepted standards. In particular, the decision to allow teachers' unions allowed the official recognition of the Korea Confederation of Trade Unions as a labour organisation. However, a number of difficult issues remain, such as whether companies should be able to pay full-time union officials, the question of allowing trade union pluralism at the firm level and the issue of unions for civil servants. The Tripartite Commission has an important role to play in helping develop more conciliatory patterns of industrial relations.

E. Regulatory reform: the telecommunications sector

Given the progress in reducing the number of regulations and improving those that remain, the focus should shift to improving the regulatory reform in key sectors, such as telecommunications. In 2000, the OECD experts on telecommunication services examined this sector as part of the report, Regulatory Reform in Korea. The key finding was an "insufficient reliance on market forces to direct" the development of this sector. The report recommended that:

Korea should emphasise the use of market mechanisms to upgrade its communication infrastructures to meet the requirements of the information society and electronic commerce. This requires a fundamental adjustment in policy..[30]

Reducing government intervention and placing greater reliance on the market mechanism will require an upgrading of the regulatory framework. First, the transition from a monopoly to a competitive market requires the establishment of an independent regulator, with powers over licensing, pricing and other regulatory safeguards. Korea is one of only three OECD countries without an independent regulatory agency in this sector. Second, it is important to reduce entry barriers by easing licensing requirements, either by introducing a class-licensing system or by establishing minimum standards rather than conducting a priori examinations of applicants. Third, price-cap regulation would be appropriate in markets where Korea Telecom remains dominant, such as leased lines and national long-distance, where it has market shares of 90 and 83 per cent,

30 *Regulatory Reform in Korea* (OECD, 2000), page 91.

respectively. However, the rationale for controlling the prices charged by SK Telecom, which has 40 per cent of the highly competitive mobile market, is not clear. In fact, MIC, arguing that there was too much competition in this market, allowed mergers, reducing the number of competitors from five to three. Korea is one of the few OECD countries that regulate prices in the mobile market. *Fourth*, the limits on foreign ownership should be further raised to boost competition and help achieve the government's plan to privatise Korea Telecom completely in 2002.

F. Reforming the pension system to cope with an ageing population

One long-term issue in all OECD countries, including Korea, is the impact of population ageing on public expenditures for pensions and health. While the ageing process is occurring relatively late in Korea, it is among the most rapid in the OECD area. Indeed, Korea's elderly dependency ratio,[31] currently the third lowest in the OECD, is projected to be the sixth highest in 2050 (Figure 14). This reflects the large drop in the birth rate -- from over five in the 1950s to 1.5 in the second half of the 1990s -- and the largest gain in life expectancy in the OECD area over that period. Indeed, it is likely to take only 22 years for the share of the population over age 65 to double from 7 per cent (a level defined the United Nations defines as an "ageing society") to 14 per cent (a level it defines as an "aged society"). In comparison, this transition took 115 years in France (Panel B). The speed of the demographic transition will be complicated by the absence of a well-developed social safety net and the weakening of the traditional pattern of children caring for elderly parents. Given the traditional sources of income support and the hitherto relatively short life span, preparing for one's own retirement is a relatively new concept in Korea.

The current public pension system has a number of weaknesses. First, less than half of the labour force contributed to the NPS in 1999, reflecting a low level of coverage among the self-employed (Figure 15). Moreover, the self-employed significantly under-report their income. The large rise in the contribution rate needed to sustain the NPS is likely to discourage greater participation. Second, it is projected that the contribution rate for the NPS will have to rise from the current 9 per cent to over 17 per cent over the next few decades to provide the average income worker with forty years of contributions a pension equal to 60 per cent of his or her average lifetime wage. Consequently, public spending on pensions, which is currently the lowest in the OECD area (Figure 16) will rise by 8 percentage points of GDP, one of the largest projected increases among OECD countries (Figure 17). Combined with the retirement allowance, pension costs will exceed a quarter of the wage bill, with likely negative consequences for labour markets and potential growth. Third, total replacement rates are rather high, approaching 100 per cent for employees who receive retirement allowances. Fourth, the lack of linkages between the NPS and the occupational schemes limits labour mobility. Fifth, the concentration of assets in the National Pension Fund -- which would approach 50 per cent of GDP even at current contribution rates -- poses some risks.

Korea has a window of opportunity to overcome these weaknesses by systemic reform of the current system, since the NPS does not begin paying regular pensions until 2008. While the government is faced with many difficult restructuring issues, pension reform should be addressed now, as it will become increasingly difficult as the current system matures and the number of

31 This is defined as the over age 65 population as a share of the population aged between 20 and 64.

persons receiving pensions increases. Pension reform should aim at increasing the role of private-sector savings for retirement, expanding coverage and limiting contribution rates to around 15 per cent, as recommended by Korea's Pension Reform Task Force in 2001.

These goals could be accomplished by the establishment of a three-pillar system:[32]

- The *first pillar*, a mandatory public pension, might consist of two parts. First, a tax-financed universal welfare pension, which would achieve the redistributive goals and overcome the problem of low coverage. The second aspect of this pillar might be an earnings-related defined-benefit pension that is actuarially fair. It would be beneficial to merge the public occupational pension schemes, which are already in deficit, into this pillar. Finally, the National Pension Fund should be operated in a way that promotes the development of long-term capital markets.

- The *second pillar* could be created by the conversion of the retirement allowance system into a mandatory corporate pension that is a fully-funded defined-contribution scheme. The allowance, which was created as a substitute for both unemployment insurance and a public pension system, has outlived its usefulness. Moreover, there is no requirement that the funds set aside for such payments be invested externally, thus making the allowances vulnerable to the financial health of the firm. Workers would benefit from the replacement of the current unfunded retirement allowance by a more secure source of retirement income.

- The *third pillar* would be a more effective system of individual pension accounts.

Health and nursing care are other areas where public expenditure is expected to rise with ageing. Korea has recently taken some bold steps to change some aspects of its healthcare system, such as separating the prescription and sale of drugs and unifying the various health insurance systems into a nation-wide scheme. The effect of these reforms is as yet uncertain. However, it is important to ensure that the current system is efficient in order to limit the impact of ageing on expenditures. A number of options could be considered, including pre-funding of medical expenditures as well as the cost of long-term nursing care, a responsibility that has been mainly borne by families. Moreover, given the increasing participation of women in the labour force and the smaller number of children per family, the traditional pattern of elderly care will need to be supplemented by a larger government role. These issues are currently being studied by a team from the OECD's Directorate for Education, Employment, Labour and Social Affairs.

G. Economic interaction between North and South Korea

Clearly the biggest uncertainty in Korea's long-term economic prospects is North Korea. The steady economic decline of North Korea since 1991 has made policies to encourage economic integration between North and South an important priority. The tragic famine has clearly demonstrated that the North Korean system is not viable and must be more open to the rest of the

32 The details of this proposal are explained in Chapter III, "Preparing for an aged society" of the 2001 *OECD Economic Survey of Korea.*

world to avoid collapse. Indeed, the past few years have seen increasing commercial links between the North and South in line with President Kim Dae-Jung's "sunshine policy".

This is a highly sensitive topic and an issue that ultimately must be settled by the Koreans themselves. The OECD, though, has expertise that can be useful in this regard. First, it has the experience of German unification, which has many potential lessons for the case of Korea. The last OECD Economic Survey *of Germany*, in fact, included a study of the decade since unification. Moreover, Germany is currently one of the "examining countries" of Korea in the country review process conducted by the Economic Development and Review Committee. *Second*, the OECD has considerable experience in advising countries making the transition from central planning to a market economy. In addition to the four former communist countries that are now members of the OECD (the Czech Republic, Hungary, Poland and the Slovak Republic), the Organisation has written Surveys of Russia, the Baltic States, Romania, Bulgaria and China. Indeed, a major study of China is due to be released shortly while work has begun on the Federal Republic of Yugoslavia (Serbia). *Third*, the cost of integrating the North and South is likely to be enormous and will require assistance from other OECD countries. The country review process and the committee structure of the Organisation may prove useful in inviting the participation of the most advanced countries.

III. Korea's role in the OECD

While the OECD has much to offer Korea in its formulation of economic policies, Korea also has a great deal to contribute to the OECD and its member countries. Korea is unique among the OECD countries for several reasons. It entered the Organisation after having been the fastest-growing economy in the world during the past thirty years. Indeed, it accomplished in one generation what other OECD countries took many decades to do. Thus, other emerging economies in the Organisation, such as Turkey and Mexico, as well as the four transition economies can learn from Korea's experience. Korea is also unique because, despite this rapid growth, it is a relatively low-income economy compared to other OECD countries. In 1998, its per capita income was 23rd, ahead of only Turkey, Mexico and Greece and the four former communist countries. Given its lower stage of development, Korea has the flexibility to introduce new policies and find better solutions than exist in the more mature member countries. In the area of pensions, for example, Korea has a window of opportunity for reform that is not available in most other OECD countries.

Korea also stands out for having successfully come through one of the worst financial crises ever experienced by an OECD member country. The 1997 crisis produced a strong commitment to reform, resulting in a rapid pace of change in a wide range of areas, as noted above. While progress in some areas has been inadequate and there remains much to do, the pace of change in Korea compares favourably with the inertia seen in some member countries. For example, the unemployment rate in Europe has remained above 8 per cent for the past decade despite all of the efforts, including the OECD Job Study of 1994, to identify policies that would reduce unemployment. Indeed, a 1999 OECD study noted that "a number of countries with high and persistent unemployment have been hesitant to implement reforms ...".[33] In sum, Korea is an example of the importance of commitment to reform. In addition, the crisis has given Korea

33 *OECD Economic Outlook*, No. 65, June 1999, p. 151.

expertise in certain areas. For example, the success of KAMCO in dealing with the non-performing loan problem has lessons for other OECD countries, such as the Slovak Republic.

Finally, the high level of human capital in Korea will enable it to make an important contribution to the OECD. In visiting government ministries, such as Finance and Economy, one meets a large number of civil servants with advanced degrees in economics and other fields from foreign universities. The intellectual capacity of the ministries is supplemented by the government-affiliated research institutes, such as KDI and KIEP, as well as institutes that are more specialised, such as KLI and KIPF. This great reservoir of human capital has a huge potential to contribute to the OECD, which operates through 140 committees composed of civil servants and other experts. Through such committees, Korea can help find solutions to common problems and participate in setting the agenda for the global economy. In addition, the Organisation benefits from the presence in Paris of a large number of Korean officials in the Secretariat. At present, ten Koreans are working as officials or consultants, while another twenty Koreans work as "project managers", who have been seconded to the Organisation. Finally, the Korea delegation to the OECD is relatively large and plays an active role. Korea and the OECD have benefited from the dynamic ambassadors, Bon Yeong Koo, Soogil Young, and Duck Soo Han, who have led the delegation.

Korea's Five Years as an OECD Member: From the Perspective of Korea's Economic Reform

Byong-Won Bahk
Director General, Economic Policy Bureau
Ministry of Finance and Economy

1. Introduction: The reason for Korea's Entry into the OECD

Ladies and gentlemen

It is a great honor for me to discuss Korea's experience as a member of the OECD with so many experts here today.

Korea had many good reasons for joining the OECD five years ago. One of the major ones was adoption of global standards in every sector of the Korean economy. This was seen as a way to ensure Korea's stable economic growth for the mid to long term.

From the late 1970s to 1997, Korea experienced average annual GDP growth rate in excess of 8%. Only in 1980 did it experience negative growth, when the economy contracted 6%. During those years, the Korean government gradually recognized that the systems that brought about the high growth were reaching their limits. Even as early as the late 1970s, the Korea government began proceeding with reforms which focused on reinforcing market oriented economic system and liberalization.

These reforms did indeed yield some notable success in the manufacturing sector, but other industries including service and agricultural sectors still remain closed and hence, backward in many ways. In other sectors of the economy, such as finance, education, labor, and real estate, which all consist factors of production, the market reforms have been delayed and less effective than originally expected. One of the reasons for this was, as you well know, resistance from vested interests and natural tendency to avoid competition wherever possible.

Out of these retarded sectors, only finance sector has made a remarkable advance and is now almost fully exposed to global competition.

In others, especially in agriculture and education, people still believes that their market can be protected and would not open their eyes and face the strict reality that they are already losing their markets. Considering that the pressure in the next Round will surely be focused upon agriculture and service industries, reform in this sectors are really urgent.

Many economists thought entry into the OECD would allow Korea to persuade vested interests and to press ahead with its reforms to establish a market oriented economic system.

2. Role of the OECD in Development of Korea's Economic Policies

Let's now turn our attention to the OECD's contribution to the overall reform of the Korean economy during the last five years.

In late 1997, the year after Korea's entry into the OECD, Korea experienced what some feel was its greatest national crisis since the Korean War – the foreign currency crisis. On the surface, the foreign currency crisis was brought about by a lack of foreign reserves. However, after a more careful analysis one quickly realizes that the crisis was due to Korea's failure to fully convert finance sector into a market oriented system.

Korea had been making efforts toward reform since the late 1970s, but it was only after the crisis with the help from the IMF that we could make significant progress in finance and labor market.

While supporting the IMF's reform program, the OECD recommended comprehensive reform for each sector of the Korean economy every year. The OECD recommendations not only set forth the direction of reform, but also were important in persuading various interest groups to consider reform more seriously.

The OECD's greatest contribution to resolving Korea's economic situation is through the annual review of Korean economy by the Economic and Development Review Committee (EDRC).

The EDRC meeting was held during each of the last four years to review the accomplishments of the Korean economy and map out future tasks. Other member countries participated in the meeting, providing their collective wisdom and expertise.

Out of this meetings come comprehensive reviews of the Korean economy known as the Economic Surveys of Korea produced by Dr. Jones and his team. I would like to take this opportunity to extend my great appreciation for their in-depth analysis and valuable recommendations.

Now, I will explain the contribution of this report in the aspect of corporate and financial restructuring, macro-economic and social policy including labor and pension policies as well.

Let me start with corporate and financial restructuring.

Regarding the corporate and financial restructuring, the OECD has consistently focused on a market-oriented approach. Especially in addressing the problem of chaebols, the OECD recommended that Korea should begin to rely on market forces rather than direct regulation, recognizing that there has been substantial improvement in the financial market, corporate governance, and the exit system of non-viable companies. Korea's recent efforts for the changes in approach on the problem of *chaebols* are in line with OECD's recommendations.

As for financial restructuring, the OECD offered the Korean government in-depth research on financial supervisory systems, development of government bond market, contagion of financial crises, and moral hazard. We also gained insight into the different systems and learned from other countries' experiences in recovering from this crisis. It is thanks to the OECD that we were able to confidently implement our financial reform and adopt global standards.

Last year, Korea was faced with a large amount of bonds maturing in a single year and the market for low-rated debt was not properly functioning. This could have resulted in the bankruptcy of a large number of major firms in a short period, thus risking a systemic crisis in the financial market. To cope with this problem, the government launched "collateralised bond obligations"(CBOs) to roll over maturing corporate bonds using partial government guarantees. The OECD showed its balanced view on the government's measures by not only acknowledging the inevitability of the situation but also cautioning the possibility of moral hazard.

Macroeconomic policy has also been indebted to the OECD report.

In 1998, The OECD expected a deep recession followed by a sharp increase in interest rates imposed by the IMF with contractionary fiscal policy. OECD endorsed supportive monetary and fiscal policies. In effect, it offered us the international support needed to implement more active stimulation policies.

Since the fourth quarter of last year the Korean economy has been suffering significant slowdown in part because of the global economic downturn. The OECD was the first international organization to deny the possibility of a second crisis because of the success of Korea's reform efforts. That was very helpful in restoring domestic and foreign investor's confidence in the Korean economy.

In regards to fiscal policy, in particular, the OECD made taxation policy the focus of last year's Korea survey report and proposed various recommendations. This report has been an invaluable source of reference for comprehensive tax reform in Korea. This can be summarised as " less exemption, broader tax base, and lower tax rate".

Now, let me turn to the social policy.

The OECD's recommendations on labor policy helped Korea effectively deal with the high unemployment that occurred in the wake of the crisis. These recommendations were based on the OECD's 'Job Strategy', which is the result of OECD's long continued study on labor market policy. They were especially important because Korea, in its history of rapid growth, had never experienced high unemployment.

The OECD also issued recommendations on the aging of the population. It used estimations on aging trends and simulations on alternatives to formulate a plan to improve the pension system. We, indeed, considered the OECD's recommendation more suitable for Korea than any other made by international organizations.

The OECD argued that the present time, when Korea does not have to worry about full-scale payment of national pensions, is the right time for pension reform. This is something Korean policymakers and the political community should heed.

Recommendations by the OECD have been useful in many other areas as well, from deregulation, privatization of network industries, to policy on SMEs, and improving efficiency in the agriculture sector.

Although the policy recommendations by the OECD are not legally enforceable mandates, they have been highly influential in Korea. Not only are they based on in-depth policy analysis from the leading experts within the OECD Secretariat, they are strongly supported by member countries -- who account for 80% of world GDP and share common values.

I would also like to mention that many government officials in Korea have learned a great deal first-hand by attending OECD conferences or by working at the OECD Secretariat. From these experiences they have improved their analytical capacities in their respective areas. This has immeasurably helped improve overall policy decision-making within the Korean government .

3. Future Goals for Korea's Partnership with OECD

Now we should continue to develop the partnership between Korea and the OECD based on the achievements upto now.

I would like to say three things in regards to the future goals of Korea in partnership with the OECD. One is to pursue further reforms for the mid-to long term growth stability, the second is to have more active participation in the OECD, and the third is to enhance the efficiency of OECD related business.

(1) Partnership with OECD in the on-going process of further reform.

First, let me talk about the partnership with the OECD in the on-going process of further reform.

Korea made substantial strides these last five years in overcoming the crisis and in implementing reforms in various sectors. I think Korea now needs to turn its attention to the mid and long term to establish a stable foundation for growth.

Some of the major tasks for the Korean economy are the following :

First, we need to go one step beyond the reform which has focused on building system and rule. Next step is to change the real practices in each sector. Only by this can we firmly establish a market oriented economy;

Second, we need to find a new engine of economic growth for the coming knowledge-based economy;

Third, we need to expand our infrastructure by establishing efficient transportation and logistics systems and create an effective land management system. This is essential to transform Korea into the hub country in the North-East Asia.

Fourth, we need to improve the quality of life by increasing the efficiency and effectiveness of the social safety net and by recognizing the need for environmentally sustainable development; and

Last but not least, Korea needs to prepare for reunification, which will almost certainly happen in the not-too-distant future.

Toward these ends, the Korean government is preparing the Vision 2011 Project for the next decade. It is part of its mid- to long-term reform plan for the Korean economy. Simply put, the direction of this project for reform is "Open World and Flexible Society."

If our experience during the last five years has taught us anything, it would be that the OECD approaches every problem from a mid- to long-term perspective. Most of the issues I presented here have already been addressed in-depth within the OECD.

If I may give a few examples: as was evidenced in "Transition to a Knowledge based Economy in Korea" which the OECD authored together with the World Bank, the OECD already had the fine-tuned analysis and policy recommendations suitable for a knowledge-based economy.

The OECD not only played an important role in proposing and developing policy alternatives in relation to environmentally sustainable development, but is also leading projects for sustainable development that take into account the environment, economy and society.

The aging population is another area of interest for the OECD. It has comprehensive information on the pension and medical systems of advanced nations, where the aging of populations is already well underway.

In the development and implementation of mid- to long-term reform plans, Korea will take full advantage of the OECD's rich experience and abundance of information.

In this regard, as I mentioned earlier in the introduction, I call upon both the domestic experts and the OECD to pay special attention to the reform of agricultural and service policies. Reforms in education and land use policy should also be examined likewise. These areas have long been subject to the heaviest restriction and protection and need to be changed to a larger degree. However, their retardedness itself means that they have the highest potential for improvement.

(2) More active participation in the OECD activities

Now let me turn to the more active participation in the OECD activities.

Until now, Korea's activities regarding OECD was passively focused on the learning of policy experiences of advanced countries, which means that Korea has not made much efforts to participate in OECD activities more actively.

Considering that only 5 years have passed since Korea's entrance into the OECD, and still there are many things to learn from advanced countries, Korea's passive position might be thought to be inevitable to some extent.

But from now on, Korea should participate in OECD activities more actively, going one step forward, it is necessary to reveal our problems to the OECD more actively so that they may be reflected in the process of setting agenda in the OECD.

Korea fully accepts the reality that the OECD must focus most of its energies on the advanced member countries including the EU and the United States. However, Korea should and will continue to emphasize the importance of increased attention to the less developed members like Korea.

As one of the newly industrialized countries, Korea has accumulated unique experiences, both successes and failures, in the course of rapid economic development.

From these experiences Korea can and must play a bridge role between advanced member countries and non-member countries in OECD's cooperation with non-member countries. For example, Korea can play an important role in the OECD's support for China's reform and liberalization.

Through this process Korea could make more contribution to OECD and deepen the relation with the relevant countries concerned.

(3) Regarding the enhancing effectiveness of OECD activities in Korea

The last issue on the future goals for Korea's partnership with the OECD is how the effectiveness of OECD-related activities in Korea can be enhanced. Regarding this issue, I will briefly present one point.

Although many Korean government ministries take part in OECD committees in their respective fields, it seems to me that no one in Korea has the overall picture about the many on-going discussions of the 140 committees and working groups within the OECD.

If we are to make use of the OECD's capacity more effectively in the course of untiring reform and to participate in the OECD more actively, it is necessary for the role of overall monitoring of OECD affairs related to Korea to strengthen and maintain a comprehensive view.

4. Closing – Suggestions on OECD Activities

I hope the OECD will continue to expand its role for the growth of Korea and global economy. On that note, I would like to close with a few suggestions on the direction of OECD activities.

The OECD has played an important part in the economic development of countries, like China and Eastern European countries, that are trying to convert to a market system. And as stated in the Korea survey report of last year and this year, the OECD is also very interested in economic cooperation between South and North Korea. While recognizing this to be a politically sensitive issue requiring close cooperation with the South Korean government, I do hope that the OECD maintains its interest in the opening and reform of North Korea.

I would also like to see an expansion in the OECD's analysis and projection work on macroeconomic conditions of OECD areas. I am fully aware that the OECD cannot allocate all or even most of its resources to macroeconomic analysis because it covers very wide range of structural issues, but there is room for improvement. It is regrettable, for example, that the OECD failed to provide immediate economic analysis or projections after the September 11th terrorist attacks.

In closing, I would like to reiterate that Korea has benefited greatly from its affiliation with the OECD. Five years is not much time, but Korea has already been able to push the economic policies needed for the next level of its maturity. I fully expect that the OECD will continue to be a valuable partner to Korea in its ongoing reform effort.

Thank you.

OECD/CLP and the KFTC, Interaction and Vision

Joseph Seon Hur
Director-General,Competition Policy Bureau
Korea Fair Trade Commission;Vice Chair, OECD/CLP

1. Introduction

01. It has been 5 years since Korea joined the OECD in December 1996. I think it is timely and meaningful to review the interactive roles of the OECD and Korea as its member.

01-a. More than 800 experts at the OECD Secretariat and representatives from member countries cover wide range of topics from traditional to new issues. In the depth and scope of analysis and discussion, other international organizations may not match for the OECD. In particular, it discovers and analyzes issues that may greatly influence on the global and local economy and provides relevant regulatory frameworks for those issues. These are something that are only allowed to OECD member countries.

01-b. Since the admission into the OECD, Korea has been engaged in various OECD Committees. In the process, Korea's legal and institutional frameworks have gone through objective evaluation. Best practices drawn from this process have greatly helped to advance Korean laws and policies. In addition, preparation for and participation in the OECD meetings in itself enabled Korea to approach conventional issues from a new perspective and remain openness to newly emerged issues.

02. Among various Committees in the OECD, Committee on Competition Law and Policy (CLP), Public Management Committee (PUMA), and Economic Development Review Committee (EDRC) are directly and indirectly linked to the Korea Fair Trade Commission (hereinafter "KFTC"). In particular, the KFTC, as competition authority in charge of competition law and policy and regulatory reform maintained close cooperation with the CLP and has participated in every CLP meeting. In June 2001, I had the honor to be elected as vice-chairman of the CLP.

The activities of the CLP are categorized into 4 major areas: carrying out regulatory reforms including deregulation, re-regulation, organizational innovation; enhancing effectiveness of antitrust enforcement; offering technical assistance to developing and transition economies; organizing the Global Forum on Competition (GFC) aimed at embracing non-member countries of the OECD

The two committees PUMA and the EDRC have supportive relations with the KFTC and have substantially contributed to KFTC's policy developments as the former has comprehensively covered regulatory reform and the latter conducts annual reviews of Korean competition law and policy.

03. A member of an organization doesn't deserve a genuine membership if it seeks only benefits from the organization. Korea is not exempt from this as it turns into 6th year as an OECD member. Therefore, I think it is time for us to move from learning stage to interaction stage so that it can contribute to the OECD discussion at a substantial level.

04. From this perspective, I would like to examine what Korea gained from the OECD, to what it can contribute and then what we are planning to do for the OECD in the future. In this presentation, I'm going to focus on the interaction between the CLP and KFTC, and then touch upon EDRC in connection with KFTC's chaebol policy and PUMA in the context of regulatory reform.

2. OECD's contribution to the KFTC

1) Best practices drawn from the OECD debates were adopted in the improvement of Korea's competition law and policy.

05. OECD debates have been a source of idea and power for the KFTC in policy design, decision, and enforcement so that the KFTC has been able to converge its competition policy into global standard and incorporate its competition-oriented views into other government agencies.

06. I believe that earnest efforts to adopt the best practices have greatly contributed not only to the KFTC's policy developments and but also to the Korean economy. If there had not been policy dialogues regarding various fields in the OECD, the discussion in domestic level would not have happened or happened so late. Even if there had happened discussion domestically, it might have ended up with only satisfying intellectual curiosity, inadequate to produce tangible policy improvement. In other words, the fact that OECD dealt with a certain topic in itself provided a momentum for discussion in the KFTC and OECD's output material served as a invaluable source of idea in improving Korean legal framework.

07. Followings are the specific policy improvements that reflect OECD's discussion results.

Reflecting 「Council Recommendation Concerning Effective Action Against Hard Core Cartels」 adopted by the OECD Council in 1998, the KFTC enacted the Omnibus Cartel Repeal Act (Jan. 1999). This is a breakthrough in cartel regulation that repealed legal exemptions for 20 cartels under 18 different laws at one time. This legislation is evaluated to have raised awareness on the role of competition authority and disseminated competition principles across all sectors of Korea. The Act produced a great effect. For example, 1999-2000 semi-annual surveys of fees of professional service providers such as lawyers and accountants found that the level of fees was on the general decrease and competition among them was increasing.

CLP discussion on "Competition & Regulation in Broadcasting Industry" discussed at the CLP in October, 1998 served as a good reference for the KFTC to reflect its opinions in enacting 'Broadcasting Act'. Specifically, the KFTC suggested that entry barriers for broadcasting operators should be eased when they try to diversify into other segments in the industry and that regional monopoly right be abolished.

The thorough analysis of Feb. 1996 CLP debate on "essential facilities doctrine" led to incorporation of the "doctrine" into Enforcement Decree of the Monopoly Regulation and Fair Trade Act (hereinafter "MRFTA") in April, 2000.

These remarkable achievements demonstrate that Korean competition authority successfully played competition advocacy role by raising its voice in the industries under privatization where the KFTC had a traditionally weak influence. In addition, 「Council Recommendation Concerning Structural Separation in Regulated Industries」 which was adopted April this year is expected to facilitate competition principle in regulated industries such as electricity, telecommunications, natural gas and the like.

Other examples of KFTC's adopting best practices discussed in the CLP are as follows:

ⅰ) "Compliance Program" discussed in October, 2000 at the CLP led to the setting up of 'Compliance Campaign Committee' in March, 2001 and the legislation of "Fair Trade Compliance Rules" in July, 2001 by the KFTC.

ⅱ) Failing Firm Defence discussed in May 1995 was used as reference when the KFTC amended M&A review criteria in April, 1999.

ⅲ) "OECD Guidelines for Consumer Protection in the Context of Electronic Commerce" approved by the OECD Council, 1999 provided inspiration for the KFTC to legislate and announce the "Electronic Commerce Consumer Protection Guidelines" in Jan. 2000.

2) Regulatory Reform

08. Regulatory reforms are mainly discussed in PUMA and since 1998, 'Country Review on Regulatory Reforms' have been underway to check if regulation enforcement and reform efforts meet OECD's best practice and to draw something to learn from the experience of member countries. In this process, I believe that the CLP played central role.

Country review in the CLP meetings have discussed and reviewed the progress of regulatory reforms in member countries regarding competition policy, energy industries and professional services in detail, while CLP delegates from competition authorities have participated in the review meetings as lead reviewers. These activities indicates that securing high-quality regulation based on competition principle is emerging as key to successful regulatory reform. From this perspective, PUMA and the CLP share complimentary and interdependent relations in enhancing the quality of regulatory reform.

08-a.

The regulatory reform regime in Korea is very similar to that of the OECD. In April 1997, "Reform Committee on Economic Regulation" was installed at the KFTC in order to propel reforms of economic regulation and a working-level task force was operated under the committee.

Later in April 1998, 'Regulatory Reform Committee' was born under Prime Minister's Office and took over the main responsibility for regulatory reform, but even after that, the KFTC has been constantly involved in the reform process in that chairman of the KFTC has participate in the Committee as a standing commissioner. In addition, KFTC has established its own internal 'Deregulation Team' in charge of regulatory reform in economic sector in the early September 1999 and has itself strongly committed to the same cause, complementing and interacting with the 'Regulatory Reform Committee'.

08-b.
The KFTC's undertakings in this regard have been strongly supported by no other than the OECD. In 'OECD Reviews of Regulatory Reform in Korea' published in June 2000, OECD praised KFTC's achievement, stating "Competition policy and enforcement are promoting two essential principles of reform in Korea: increasing reliance on markets to drive growth, and increasing openness of both public sector and market institutions." The evaluation also had it that "the KFTC is independent and well-placed, and plays a central role in major reform efforts." This strong endorsement from the OECD made the KFTC more committed to the regulatory reform and promoted the legitimacy of its policy direction at home and abroad.

3) The area most actively discussed between the OECD and KFTC has been *chaebol* policy.

09. The chaebol policy aims at regulating inefficient and anti-competitive business practices. To reduce concentration of economic powers by the *chaebols*, the KFTC employed regulatory tools such as 'Total Equity Investment Ceilings', 'Cross Debt Guarantee Prohibition', 'Cross Investment Prohibition' and so on.

10. However, the OECD regarded this issue not as competition policy issues but as the issue concerning corporate governance and financial soundness that should be solved by market force. For this reason, the OECD made a recommendation that the KFTC focus on the traditional competition issues other than chaebol issues.

11. The KFTC's has seen the matter from the different viewpoint, given the Korean economy's unique situation characterized by monopolistic market structure and lack of corporate monitoring mechanism. For this reason, the KFTC made strenuous efforts to narrow the differing view with the OECD on the following grounds:

① The chaebol policy under the MRFTA is in line with competition policy.

Chaebol monopolized input markets such as financial and human capital, through circular investment, cross debt guarantee and undue internal transactions, leading to the distortion of allocation of the economic resources. Through such business practices among chaebol-affiliates, the chaebols produced "Entrenchment Effect" blocking new entries in the market or driving competitors out of the market. In addition, protecting chaebol-affiliates from market competition and thus undermining innovation led to weakening of their competitiveness. Cross support among affiliates delayed the exit of weak affiliates, distorting sound capital flow to productive sectors.

For these reasons, competition authority has intervened in the market to remove inefficiency stemming from the monopolization of the input markets and to build level playground where chaebol-affiliates and independent corporation can compete under the same conditions.

② The chaebol policy in the MRFTA is complementary tools for corporate governance reform.

It is true that another "chaebol problems" such as non-transparency in accounting and management, and arbitrary and irresponsible management by the owner are deeply related to the issue of corporate governance and financial supervision.

Even so, considering the Korean economy's unique situation, it is insufficient to address the problems only by changing corporate law and strengthening financial supervision. Moreover, it will take substantial time for the recent reform in corporate governance and financial sectors to be implemented in the real practices of economic players.

Therefore, to ensure that corporate monitoring mechanism works properly, not only that relevant laws and institutions need to be reformed, but also that supportive competition policy needs to be implemented.

③ Competition policy varies from country to country and from age to age.

I believe that economic policies including competition policy of a country should evolve in consistent with its economic development stage and satisfying its specific needs. In line with this, the unique situation of the Korean economy demands additional policy consideration based on the traditional competition policy.

A weakening of the chaebol may bring about the weakening of the entire national economy due to chabol's large influence on the economy. We experienced this situation from the economic crisis in 1997. The weakening of one chaebol-affiliate supported by cross debt guarantee and undue internal transactions escalated into the crisis of the entire group, which leads to weakness of the nation's financial system. The whole costs incurred from this vicious circle ended up as a burden to tax-paying citizens.

12. Through the in-depth and heated debates, the OECD and KFTC are now beginning to find a common ground in chaebol policy. In 2001 OECD EDRC report, the OECD diagnosed that what is necessary for the easing of the chaebol policy is more transparent corporate governance, financial improvement, and market-based business practices. The KFTC also forecasts that if the day comes when capital and financial markets perfectly function and corporate monitoring works well in the future, the current chaebol policy will be naturally eased as the OECD pointed out.

4) Active involvement in the OECD largely contributed to the capacity building of the KFTC

13. The KFTC was able to develop an insight and policy issues through strong activities in the OECD meetings. In the earlier phase, the KFTC sent private sector experts like professors and researchers. Currently, however, working level policy makers and enforcers are participating constantly in the OECD meetings.

Thanks to this direct engagement, policy workers have been exposed to updated debates in the OECD; they have analysed the OECD Secretariat paper and member country's national report from policy perspective and drawn the best practices. Therefore, it has become easier for currently developing discussion in the OECD to be delivered throughout the KFTC so that KFTC policy makers may develop policy-oriented mindset and a strong enthusiasm to meet the global standard.

14. Active participation in the OECD/CLP provided a foundation for the KFTC to extend active involvement to the international organizations such as WTO and ICN.

Given that invaluable outputs of OECD meetings becomes a basis for discussions in other international organization, participation in the OECD strongly encourages the KFTC to join the talks in the other international organizations. Also, my election as the CLP vice-chairman in June 2001 provided a strong endorsement for me to be elected as Chairman of Membership Working Group of the International Competition Network (ICN).

In addition, the confidence gained from the participation in the CLP meetings virtually led to the KFTC's greater alliance with other countries' competition authorities in WTO 'Working Group on Interaction between Trade and Competition Policy', so that competition issue could be included in the agenda of New-Round in the 4th WTO Ministerial Conference held in Nov. this year.

15. The involvement in OECD/CLP meeting itself worked a lot for the growth of the KFTC and Korean competition law and policy. CLP meeting consists of Committee on Competition Law and Policy (CLP), Working Party No.2 (WP2), Working Party No.3 on International Cooperation (WP3) and Joint Group on Trade & Competition (Joint Group). These series of meetings usually last 5 days to discuss various competition policy issues.

To actively intervene in the CLP meetings, the KFTC has made enormous efforts to analyze contents of agendas and to draw up country report for submission to the OECD. Thanks to these endeavors, the KFTC could make competition law and policy of Korea more relevant and sophisticated. Thus it was possible for the KFTC always to be opened and flexible.

16. Both the results of the OECD discussion including 'OECD Council Recommendations' provided sources of legitimacy and justification for the KFTC in enforcing competition law and policy. Competition policy, after all, needs to be supported by private compliance. OECD's endorsement in the form of recommendation has been a source of energy for the KFTC in making and enforcing competition law and policy.

3. KFTC's contribution to the OECD

〈Quantitative aspects〉

17. Since Korea's accession to the OECD in 1996, the KFTC has so far participated in the CLP 15 times, submitting approximately 30 written documents for the CLP meetings.

Initially, the KFTC mainly focused on introducing Korea's basic competition law, MRFTA and competition policy at the CLP meetings.

Recently, however, the KFTC began to turn its eyes to other various concerns, such as the fields of natural gas, e-commerce, transportation, communication, access pricing, state aid and so forth. In such efforts, the KFTC have turned in 2 or 3 discussion papers to every roundtable discussion of the CLP with a view to drawing the best practices.

18. Meanwhile, I would like to mention that the KFTC has made strenuous efforts for the successful launch of the 1st Global Forum on Competition (GFC) organized by the OECD, October 2001.

The GFC is a multilateral forum designed to disseminate the competition policy on a global scale by disseminating competition principle into the non OECD member countries.

To be more specific, the GFC invites 20 some developing countries which are non-OECD members, and prompts active discussion on international cartel, transborder merger and role of the competition authority in economic reform.

Recognizing the importance of the Forum, the KFTC has made voluntary financial contribution to the OECD for the successful launch of the GFC. The KFTC also made a presentation at the CLP meetings on what topics developing countries in Asian region and transition economies in eastern Europe on the basis of the survey.

By the same token, the 6th 'International workshop on Competition Policy' co-hosted by the KFTC and the OECD held in July 2001, functioned as the preliminary gathering for the 1st GFC, and provided an insightful input for the future direction of GFC's work.

〈 qualitative aspects 〉

19. Due to Korea's relatively short membership in comparison with other member countries, at an early stage, the KFTC participated in the meetings for a learning experience. Korea, however, is currently trying to move toward interaction phase from learning phase. In this regard, I believe the KFTC can contribute to the OECD in the following areas.

Technical Assistance to Developing Countries

20. Since 1996, the KFTC together with the OECD has hosted International Workshop on Competition policy for developing countries. From 1999, the scope of participants was expanded to transition economies in the East Europe in the OECD/KFTC Workshop. As mentioned earlier, the 6th Workshop in July 2001 set the stage for the successful launch of the 1st GFC. Other international organizations such as the WTO, UNCTAD, World Bank recognized that the Seoul Competition Workshop largely contributed to the dissemination of competition policy in the APEC region.

21. I believe that the KFTC has comparative advantages over other member countries in carrying out technical assistance on the following grounds:

① Korea, as a developing economy, has a 20-year experience of competition law enforcement. ② Through continued technical assistance, it identified the needs of developing countries and experienced in policy dialogue with developing countries. ③ Asian countries like Indonesia, Vietnam, the Philippines, etc. and transition economies like Rumania are eager to benchmark the Korean competition law model which was introduced in the development era.

Using these advantages, Korea intends to serve as a strong bridge between developing and developed countries. Besides hosting workshop for developing countries, it plans to develop new technical assistance programs. Of course, it will keep on actively engaging itself in the outreach initiatives of the OECD, IBA, UNCTAD and so forth at their request for the participation of the KFTC.

Competition Advocacy Role

22. Powered by 3 rights - ① Right to speak in the cabinet meeting as a minister-level chairman of an independent administrative body, ② right to prior-consultation of competition restraining legislation, ③ right to raise issues to and participate in the meeting of Regulatory Reform Committee, the KFTC is playing a strong advocacy role in the reform process. In this regard, I believe that the KFTC's various experience in carrying out competition advocacy role will contribute to the CLP discussion and technical assistance program. For example such experience from advocacy role provided a source of energy for KFTC's policy makers including myself to conducting country reviews as main examiners.

4. Future Direction for the Activities in the OECD

23. As a member country, Korea intends to be more engaged in OECD debates, establishing clearer view of the OECD. To be more specific, the KFTC fully recognizes that OECD discussion results are precious source of policy and institutional improvement so that the Korean competition law and policy can be converged into global standard. Meanwhile, recognizing that there are some areas that the KFTC can contribute to, it will strive to constantly find such areas in order to shift from learning phase into interaction phase.

24. Based on this clear recognition, the KFTC wants to reaffirm its commitment to substantially contribute to the CLP discussion, rather than getting complacent about quantitative achievements such as elections as the bureau member of the CLP and GFC and co-hosting of 'International Workshop on Competition Policy Workshop' with OECD.

25. To fulfill its commitment, the following efforts may be considered.

Stage of Preparation for the CLP meetings

Rigorous agenda analysis needs to be performed by utilizing aide-memoir and records of the past meetings. The KFTC has a strong belief that through preparation rather than post-meeting work will be a great help for the interaction between the OECD and the KFTC. And intensive debates between staffs of the KFTC and the private experts will produce high-quality national reports that will be submitted to the OECD Secretariat.

Stage of Participation in the CLP Meetings

With the head representative to the meeting, working level staffs also need to participate flexibly in the meetings according to agenda. By doing so, the KFTC can be substantially involved in the CLP discussion and then reflect the results more effectively in domestic policy developments. Working level officials also need to actively intervene in the meeting so that they can enhance their capacity of discussion in the global forum.

Follow-up Stage after the CLP meetings

The analysis of discussion results and drawing policy implications for policy developments need to be followed. The KFTC has issued the follow-up reports of the CLP meetings and distributed them throughout the KFTC, building them in its internal electronic data base so that they can be easily accessible to every staff in the KFTC.

At the early stage after it joined the OECD, the KFTC released follow-up reports composed of English materials, which fell short of drawing attention from the staffs in the KFTC. Recently, however, the participants to the CLP meeting issue exhaustive follow-up reports based on the translation of English materials on every agenda into Korean and some policy implications. These efforts are welcomed by the KFTC staffs.

In addition, not stopping at drawing policy implication from the CLP discussion, the KFTC is making every effort to adopt best practice if it finds policy implications can be developed into concrete policy improvement. Compliance program is the best example in this regard.

Meanwhile it will be desirable for the participants back from the CLP meeting to make presentation on the CLP discussion in public in order to draw the attention of other KFTC staffs. By the way, policy issues requiring further analysis and research can be outsourced to private experts. Also, efficiency will be increased by going over the problems arose in the stage of preparation and participation in order not to repeat them in the next meeting.

Concerning the agenda involving other government agencies, the KFTC is willing to talk with related agencies before going to the CLP meetings and then inform them of the results to constantly raise necessity of policy dialogues with related agencies and to make them reflect competition principle into their policy design.

* 「Council Recommendation Concerning Structural Recommendation in Regulated Industries」 was adopted in the OECD Council in April, 2001. Before adoption of the Recommendation, the KFTC held meetings with other related agencies in the Korean government in preparation for the adoption. Now that the adoption was made, the KFTC is encouraging related government agencies to implement the Recommendation.

26. Beside what was mentioned earlier, the KFTC will constantly develop the technical assistance program for developing countries and actively participate in the international forum such as regional workshops organized by the OECD. In addition to hosting 'International Workshop on Competition Policy', the KFTC will send instructors to the OECD's various technical assistance programs. The KFTC will also dedicated itself to the advance of its competition law and policy with active participation in other OECD meetings co-hosted by the CLP and other OECD committees. The KFTC intends to intensify cooperative relations with other OECD member countries faced with similar policy challenges by forming informal inner discussion group. In addition, to address international competition issues and enhance mutual understanding between member countries, the KFTC will continuously hold bilateral consultations during the CLP meetings.

Comment

Yong-Kyun Cho
Professor
Institute of Foreign Affairs and National Security

It is an honor for me to be in this prestigious seminar and to express my personal opinion of the OECD contribution to the Korean economy.

Five years ago when Korea joined the OECD, we had a seminar in which we discussed expected contribution of the OECD to the Korean economy and some roles Korea would play as a new member of the OECD. As far as I remember, the expected benefits we discussed in that seminar were: (1) to improve the capacity of policy setting and their implementations, (2) to participate in discussing and establishing new world order in its early stage, (3) to have an easier and wider access to valuable information produced by the OECD, and (4) to enhance the economic and diplomatic status of Korea. We were also concerned about increasing instability in capital and financial market caused by the rapid liberalization after joining the OECD. Now, in five years, we have another similar seminar to evaluate the relation between the OECD and Korea during the past five years. It seems to me that the expectations then were mostly right. Our participation in the OECD has been very beneficial to the Korean economy in various respects mentioned above.

Looking back upon the past five years, there have been drastic changes in the Korean economy. The foreign currency crisis, which is actually comprehensive economic crisis, hit the Korean economy right after the entering into the OECD. Some argued that too early liberalization of the Korean capital and financial markets was, at least, partly responsible for the crisis. Many others, on the other hand, insisted that causes of the 1997 crisis were very comprehensive and structural, and dated back to far earlier than the mid-90s. Whatever the real causes are, it is clear that the OECD evaluation of the Korean economic situation, and its policy recommendations were so invaluable that we could not have successfully overcome the crisis without the help of the OECD. Various advice of the OECD contributed much to the early recovery of the Korean economy. In this sense, the role the OECD has played during the past five years should be estimated very affirmatively.

Concrete contributions of the OECD are well explained by the three paper presenters. I would like to thank them for the very enlightened papers. Contribution of the OECD is all the more important to Korea, relative to other member countries, because the Korean economy is now in a crucial stage. We should continue or strengthen our efforts of on-going structural reform and thereby move into more advanced stage of the national economy. In this context, I am very impressed with Dr. Jones' paper, its second part in particular. It clearly indicates what we should focus on to continue the reform efforts in the future. I think it proper to emphasize the importance of enhancing transparency and efficiency in setting and implementing policies for the completion of the shift to a market-based system. It is also timely to point out the importance of the review of the tax system, pension system and social safety net. Dr. Jones' recommendations should be kept in mind for securing the basis of sustainable growth of the Korean economy.

Recognizing the contribution of the OECD so far, we need to emphasize more its future contribution. For this purpose, it would be useful to address an issue of whether we have fully exploited the potential benefits of being a member in the past, and what we should do for that in the future. First, when we think of the OECD, our concern so far has focused excessively on the diagnosis and evaluation of the domestic economic problems of Korea. They were useful, important, and in a sense inevitable in view of recent economic situation of Korea. But now we need to extend our concern and activities to wider areas in the OECD. Various in-depth researches and discussion of emerging international issues in the OECD are increasingly important to Korea in the sense that they may affect our economy more in the mid- and the long-run. An active participation in those activities should be emphasized more in the future. Second, the results of researches, discussions and various other works in the OECD should be given wider publicity in Korea. They are useful not only for policy makers of Korea but also for the private sector including business people and NGOs. All three presentations emphasize the contribution of the OECD to the public sector activities only. For the ultimate and effective operation of a market-based economy, the mindset of private sector agents should change. But many of them do not know much what's going on in the OECD. Third, for more effective exploitation of the potential of the OECD, we should have a larger number of and more qualified specialists. Encouraging active participation of specialists from the private sector is necessary. More effective administration of personnel in the government sector is also helpful. Continuous participation of the same group of personnel in various activities will contribute to enhancing their expertise and establishing international networks with their counterparts in their areas. Lastly, from now on, we need to pay more attention to activating discussion of inter-Korean economic cooperation within the OECD. The OECD has accumulated useful experiences and information of some transitional economies, including the experience of the German unification, thus it can provide them to Korea for more effective economic cooperation between the two Koreas. Discussion of this issue on a multilateral basis as in the OECD will contribute to attracting global concern to this issue and ensuring wider participation in inter-Korean economic cooperation.

In referring to the economic cooperation between the South and the North, Dr. Jones mentioned that the issue must be settled by the Koreans themselves. It is basically right but it should be recognized that the issue also retains its international nature. Inter-Korean cooperation requires enormous amount of investment capital, which is beyond the South Korean capacity. Thus assistance of international society, international organizations in particular, is indispensable. In addition, peace on the Korean peninsula which can be acquired through strengthened cooperation between the two Koreas, is a kind of security cost which the global society should bear together. We may consider the role of the OECD in this context.

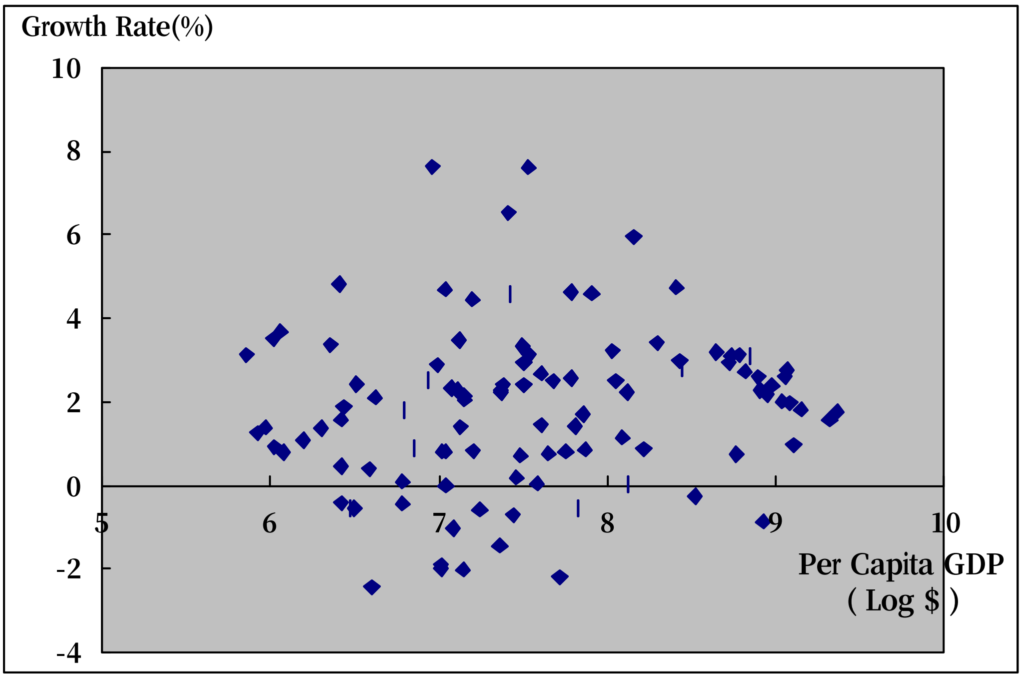
Concerning the chaebol policy presented by Director-General Hur, I have a short question. Direct-General Hur mentioned the OECD and KFTC began to find a common ground for the chaebol policy of Korea, but it seems to me that there still exists a remarkable gap in their recognition and policy prescriptions between the two. The OECD emphasizes the transparency in corporate governance and financial soundness, while KFTC retained a position that perfect function of capital and financial market should precede the ease of current chaebol policy. My question is perfect function of those markets cannot be obtained without the transparency and the financial soundness of corporate sector. They are complementary each other and should be pursued simultaneously. One does not precede the other. I want to hear from you about this view.

Thank you!

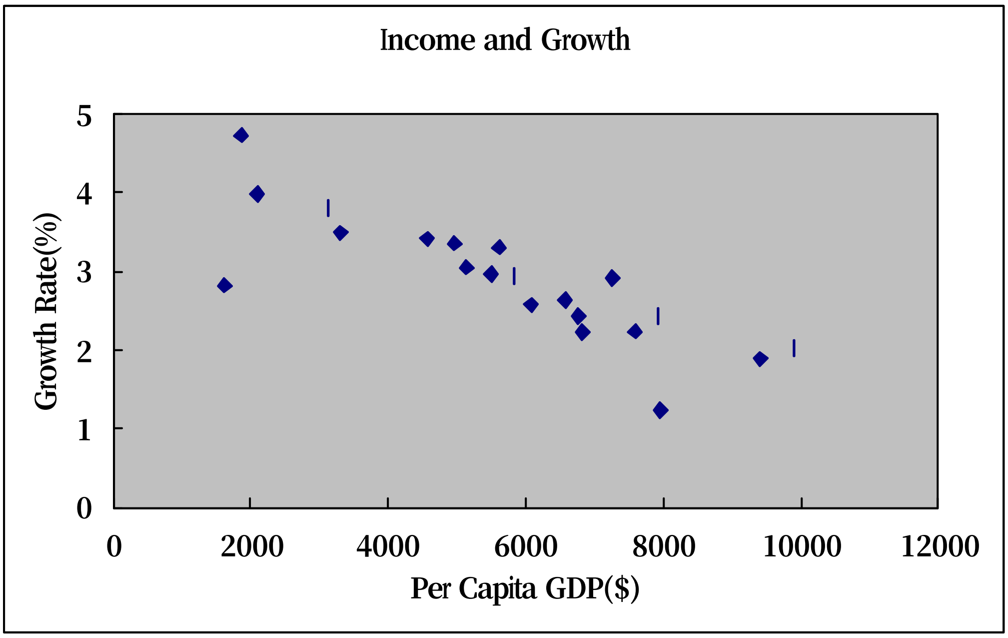
Comment

Kyung-soo Kim
Professor
Sungkyunkwan University

I fully agree with Mr. Jones on his emphasis on establishing and upgrading market oriented financial system in Korea's post crisis management. Before I make specific comments on Mr. Jones' presentation I would like to show two graphs. In the first graph the horizontal axis represents per capita income in 1960 and vertical axis average per-capita GDP growth rate during 1960-90. 105 countries' per-capita income and growth rate have been plotted in the graph. As you can see there's no systemic relationship between per-capita income and growth rate. This is against the convergence hypothesis the classical growth theory predicts: lower-income country will have higher growth so that poor country will catch up rich country.



On the other hand, in the second graph 21 OECD member countries as year of 1965 have been selected. Unlike the first graph it appears that there is a systematic relationship between per-capita income and growth rate. This is so called conditional convergence: when countries have similar economic environment poor countries will catch up rich countries. The classical growth theory survives. In fact, the conditional convergence still appears to hold when you choose countries having significant degree of openness in terms of international trade. What is this all about? Korea should do her best in accommodating legal and institutional norms in OECD countries.



On the financial sector Mr. Jones has emphasized forward-looking criteria (FLC) and prompt corrective action (PCA). Both FLC and PCA are key elements for upgrading prudential standards, as Mr. Jones puts, in line with the norms in OECD countries and turns out to contribute Korea's financial restructuring. For example, when FLC was introduced first time at the end of 1999 it raised the size of non-performing loan held by banks by 26.2 trillion won, which required additional public funds. Consequently, in September 2000 the Korean government had to mobilized the second round public funds of 50 trillion won.

Without FLC the economic costs of financial crisis would have been much larger. Looking at panel data of many countries economists realize that repeated, incomplete recapitalizations tend to increase the overall fiscal costs of resolving a banking crisis. Because marginally capitalized banks tend to engage in cosmetic corporate restructuring, such as maturity extension or interest rate reduction on loans to non-viable corporations, rather than debt write-offs (Honohan and Klingebiel, 2000).

Since IMF crisis Korea has build up institutional framework for market oriented financial system. This institutional building should meet standard of most OECD countries. In order to make strong institutional environment, however, I think transparency, accountability and credibility are the most important factors Korean government has to focus. In order for FLC and PCA to work properly banks should have right incentives and at the same time should provide reliable data. I fully agree with Mr. Jones on privatizing nationalized banks.

When it comes to bank resolution the striking difference between Korea and U.S. is that in U.S. the duration of bank nationalization is short, 10 months at longest. However, in Korea it would take years. As a matter of fact it turns out that financial consolidation in Korea as in other emerging market economies with the exception of H.K., Singapore and some Latin American countries has been a way of resolving banking crisis. Government instead of market forces has played a major role in consolidation process. Political economy such as insufficient trust in market, bad feeling of foreign participation in domestic financial market and concern on fire sales may explain the difference. Currently making the financial holding company comprising five commercial banks and one merchant bank and other nationalized banks competitive is in the highest priority.

One last comment. In addition to financial opening Korea has fully liberalized foreign exchange transaction, which may cause severe restrictions on macroeconomic policy. This is so called Mundellian impossible trinity: you cannot control foreign exchange rate and interest rate at the same time. The Mundellian impossible trinity may exacerbate capital inflows problem. Some economists claim that for emerging market economies even free movements of capital and floating exchange rates are incompatible. Consequently, some controls on capital flows, especially short-term capital flows, have been recommended. However, capital control may be a safety net and it does not cure the problem. What Korea needs to do is to have well-developed and sophisticated financial market. Especially, term money market has to be developed and market liquidity needs to be enhanced so that the benefit of foreign exchange market liberalization can be fully exploited

REFERENCES

Honohan, P. and D. Klingebiel, “Controlling the Fiscal Costs of Banking Crises," Policy Research Paper 2441, World Bank 2000.

Comment

Young-Ki Lee
Professor of Public Policy and Management
Korea Development Institute

Papers presented by Dr. Jones, Mr. Bahk and Mr. Hur not only present details of OECD policy recommendation, but also the process and mechanism of the policy consultation. Moreover, their work clearly explains about the disagreement arising in relation to the policy.

All in all, the papers allow the readers to glance at changes in economic system toward advanced and internationally compatible one after Korea became a member of OECD.

So far, numerous reports, papers and documents issued by OECD helped its readers to get objective views on Korean economy. This objective evaluation of Korean economy will greatly contribute for the Korean government in policy-making. Continued effort of OECD in issuing balanced and objective views on Korean economy is a valuable one, especially the part where economic issues are seriously politicized.

Now I will discuss about the Korea's corporate governance reform, which is the area I am supposed to discuss mainly today.

As Dr. Jones's paper mentions, major reforms have been implemented in the Korean corporate governance system. Since 1995, the governance issue became a topic of heated debate in Korea. Although there were strong resistance from the business sector during the early stage of debate for the governance reform, criticism against the major deficiencies in Korean business practice and governance structure became intensified after the outbreak of the Korea's economic crisis.

In line with the IMF rescue package as well as OECD recommendation, Korean government placed the corporate governance reform on the top priority among the structural reform.

The reform measures have focused on enhancing the transparency of corporate information, strengthening the responsibility of corporate management and auditors, strengthening the right of minority shareholders as well as institutional investors, and enhancing the role and responsibility and function of the board of directors. All listed companies and most of financial institutions are now required to elect outside directors in their boards.

Furthermore, from 1998 institutional investors are allowed to exercise their voting rights. Before, they could only exercise neutral "shadow voting". Regulations in M&A has alleviated to enhance market discipline on corporate management and to facilitate corporate restructuring. In addition, holding companies have been newly established in Korea to facilitate restructuring of Korean chaebols.

In September 1999, the Committee on Corporate Governance announced the Code of Best Practice for Corporate Governance to guiding corporations towards improved governance structure and practices. Every year, the Korea Stock Exchange selects best Corporation, CEO and outside directors performing right governance practices.

New environment in corporate governance can be evidenced by increased recognition of the importance of corporate transparency, reinforced accounting regulations, improved perception on the fiduciary and legal responsibility of corporate managers and board members. In fact, hundreds of owners or "chairmen" and managers of private firms have been punished for their illegal or fraudulent management. Penalty was imposed to number of certified accountants and accounting firms for their illegal accounting practices. Such changes due to corporate governance will contribute to improve the future business practices in Korea.

However, there are remaining obstacles and challenges for the advanced governance system to be established in Korea. Despite dramatic changes in various area of corporate governance, many parties are not well accustomed to the new system. More than 1,800 outside directors are needed under the new system, but there is not sufficient number of qualified candidate for this position.

In the light that the corporate governance system is a mechanism of resolving interest conflict among various corporate stakeholders, well functioning of the new corporate governance system can be guaranteed in a truly full-blown market economy.

In such respect, any remaining government interventions in the market, although some of them may be necessary for the restructuring, will have to be abolished.

Since the distorted governance of banks and financial institutions prevailed in the past was the main source of structural deficiency of the corporate sector and ultimately the whole economic system in Korea, straightening out the governance mechanism of the financial institutions will be the core task for the advancement of the nation's economic system.

As Dr. Jones mentioned in his paper, the banks and financial institutions "nationalized" during the financial restructuring will have to be privatized as soon as possible. If not, it will repeat illegitimate lending behavior of the past. Unless a sound governance system is set up and effective market discipline is guaranteed to work in the financial sector, there remains a possibility that politically motivated or illegitimate lending practices of the past may repeat, as we have seen from the cases of many troubled financial institutions and corporations.

Comment

DoHoon Kim
Research Fellow
Korea Institute For Industrial Economics & Trade

First of all, I would like to extend my gratitude to the organisers of this forum for giving me a chance to exchange views with such distinguished experts.

The organisers have asked me to speak about the OECD's role to Korea's regulatory reform policy as well as to comment on the papers presented in the session. However, this time, I will focus on the first task. I have two reasons for that. First, we already heard the comments made by three eminent panelists. Second, unfortunately, I received only one paper, Director General Park's one, when I had to leave for Paris to take part in an OECD meeting. The purpose of this travel was to examine the regulatory reform of Canada from the market openness perspective. I played the role of an examiner in that meeting. This can be also regarded as an evidence of the active interaction between the OECD and Korea in terms of regulatory reform.

Korea had already embarked on regulatory reform, which was called at that time deregulation, even before entering into the OECD, that is in the early 90s. However, despite the great effort that had been put into for deregulation, the result was not satisfactory. Potential beneficiaries of deregulation, consumers and business people, kept complaining about the heavy burden of governemnt regulations even after the government's strong drives of deregulation.

In the end, the Korean government realized that it is more important to manage its regulatory system rather than trying to reduce the number of regulation.

At that time, the policy recommendations set out by the OECD in 1995 and the 1997 OECD Report on Regulatory Reform became good guidances for the Korean government to change its policy directions from deregulation to regulatory reform. Govertment's new approches such as cost/benefit analysis and sunset clause were introduced in this period.

The regulatory reform policy reached its climax when the current government launched reform-driven economic policies just after the Korean economy had been severely hit by the unprecedented financial crisis.

First, the government cut off the total number of regulations by half and improved 40% of the remaining half just in one year.

Second, the government introduced a very well established regulatory impact analysis system. Through this system, all regulatory agencies are forced to attach the impact analysis on economic growth, competitiveness, government budget and international trade to their new regulatory proposals. Of course, this system was also inspired on the discussions made in the OECD.

Getting confidence form these measures, the Korean government poised to be one of the first 8 countries to be reviewed by the OECD in terms of the regulatory reform policy. The OECD reviews on regulatory reform are composed of three main thrusts; government capacity to build up good quality of regulations, market openness, and competition policy. In addition, special reviews focued on two selected sectors such as telecommunications and electricity are also conducted.

Facing many difficulties including hard resistence from labour union, the Korean government managed to introduce certain degree of market competition including competition from foreign parties to these once highly regulated or even monopolised sectors. One should admit that this was possible because Korea applied to be reviewed by the OECD.

The OECD Report on Korea's Regulatory Reform was published in 1999. The report suggested several recommendations to the Korean government. The Korean government accepted to apply most of those recommendations and is applying them in regulatory reform policy as well as other economic policies.

These days, the Korean government seems to be quite confident of its regulatory management system and the outcome resulted form this system, so that they want to share its experience with other countries. That is one of the reason why the Korean government recently committed to organizing the 3rd OECD-APEC Forum on regulatory reform in Ocober next year. This is also a strong evidence of the willingness of the Korean government to enhance the dialogue with other OECD countries and to share policy ideas with other APEC members in terms of regulatory reform policy.

The regulatory reform is certainly not a finished business in Korea. Korea will keep a close cooperation and dialogue with the OECD in its further efforts for regulatory reform. Thank you for your attention.

SESSION II

Structural Adjustment and Systemic Risks

Structural Adjustment and Systemic Risks

Wolfgang Michalski
Professor of Economics, University of Hamburg
Former Director, International Future Programme, OECD

In a world of increasing interdependence and growing complexity systemic risks represent a major concern for public policy makers. Yet, in spite of its topical significance, a universally recognised definition of this specific kind of risk does not seem to exist. Most definitions have in common that an initial small shock or failure is amplified so that it threatens the functioning of a whole system. Definitions differ widely, however, with regard to the kind of menace, the reason for a possible crisis or the relevant systemic multipliers.

The first part of this paper will therefore seek to provide a suitable definition of systemic risks in the structural adjustment context. Thereafter, in the second section, the focus is on the two-way relationship between macro-economic performance and flexible adjustment in product and factor markets. The paper will then deal with the general case for government intervention in a market economy, before it addresses in the fourth section the reasons why political ideology and reality of government policies are frequently not in accordance with each other. Finally, an attempt will be made to suggest a number of intervention criteria and implementation principles which could bring theory, ideology and reality closer together. This will be done in two steps: first, with respect to structural crises in general and then, with regard to support policies to declining industries in the light of systemic risks.

I. The Notion of Systemic Risks in the Context of Structural Adjustment

Systemic risks can be observed in conjunction with natural disasters where the consequences of an earthquake, a freak-storm or a major flood can result in significant disruptions of normal economic and social life. Systemic risks can be associated with the growing dependence of modern economies and societies on technology. In particular, a breakdown of electricity supply, of data or communication networks or transport systems could cause economy-wide negative spill-over effects. The vulnerability of the global economy with respect to the possibility of politically induced supply interruptions on world oil markets represents yet another kind of systemic risk. Furthermore, the global implications of the 1998 financial crisis in developing countries in Asia and Latin America are also an illustration of this phenomenon.

In essence, all these examples show that the notion of "systemic risk" is a catch phrase which is used to describe many different kinds of problems. For the purpose of this paper which focusses on structural adjustment issues, it appears therefore justified to leave any attempt towards a universally applicable definition aside and decide pragmatically that the notion of a systemic risk is used in the following as the potential for negative overall economic and social repercussions caused by a specific shock or failure at micro-economic or company level.

For the majority of crisis situations in the non-financial sector which is the focus of this paper, this definition can obvioulsy be applied in a relatively narrow sens. This means that it can be restricted to those cases where the propagation of the negative effects is primarily a consequence of strong externalities which affect a whole "bundle" of economic activities. A more comprehensive view of systemic risks may be needed if the analysis also encompasses the financial sector. In that context the definition would no doubt also have to integrate bank failure contagion with financial market spill-over effects and more general payment and settlement risks.

II. Overall Economic Performance and Structural Adjustment.

A market economy is a dynamic and powerful mechanism to convey complex information about social preferences, business opportunities and technological possibilities to economic agents in markets for goods, services, capital and labour through the indirect means of prices as well as profits and losses. When this system works according to its theoretical foundations, it confronts producers and consumers with information not only about present but also about future conditions and induces people to make timely adjustments in production and demand structures. Moreover, it is important to note that the relationship between structural adaptation and overall economic performance goes both ways.

Not only does flexible adjustment at micro level effectively support macro-economic performance; but micro-economic flexibility is also greatly assisted by macro-economic stability. Steady expansion of demand, low inflation, solid public sector finances and external equilibrium favour spontaneous responsiveness of markets to change. In contrast, markets easily fail to fulfil their social role adequately if macro-economic disturbances overshadow market signals and create additional risks for investment, innovation and structural adaptation more generally. In short, there is either a virtuous circle of micro-economic flexibility and macro-economic stability or a vicious circle of rigidity and instability.

This basic message is true for the most advanced countries as well as for developing economies. Looking to the past, the superior overall economic performance of Asian industrialising countries which adopted an open market export-led growth strategy compared to the Latin-American experience with the protectionist and defensive import-substitution approach is a good general empiral illustration of this statement.

However, despite all the forceful arguments which support the view that competitive markets are a highly powerful instrument in support of dynamic wealth-creation, there are many instances where governments have an important role to play not only in contributing to an adequate general political and social environment and in providing the ground rules for market operation, but also in intervening in the economic process, whenever it can be ensured that government intervention can make a positive contribution.

III. The General Case for Government Intervention in a Market Economy.

It is generally recognised that markets neither automatically ensure full employment and price stability, nor guarantee harmonious regional development. Markets are also unlikely to anticipate future economic and social needs correctly in some areas of economic activity, either because external effects prevent prices from reflecting fully relevant social benefits and costs or because not all important information is easily accessible. In other cases markets may be distorted by concentration of market power which can counteract flexible adjustment, cost cutting and innovation.

In all these cases and various others where market failure *de facto* occurs, a frequently difficult policy choice has to be made between government action to remedy the consequences of undesirable outcomes, and policies that remove the cause for failure and enhance the functioning of the competitive system. To the extent however that market failure is proven there is broad consensus that – if possible – indirect or otherwise direct government intervention as such is needed.

The controversial debate starts when markets are indeed functioning as they should, but where either the speed of change or the cumulative effects of change result in adjustment costs which from an overall economic or social perspective are to be considered as excessive. The condition of a systemic risk in this context is most obviously fulfilled if such costs are the consequence of the proliferation of structural difficulties across a whole bundle of economic activities.

There are several cases where such situations can arise. Most prominent among these are situations where the negative repercussions work through particularly intensive up-stream or down-stream linkages where indirect employment is much higher than direct employment. This is the case in the car industry in many countries. Extreme adjustment pressures can also arise when major abrupt changes in a number of supply and demand factors hit an industry simultaneously and reinforce each other. This appeared to be the case in many crisis industries such as consumer electronics in the early 1980s.

Purist advocates for the market economy could be tempted to argue that as long as markets function adequately, there is no reason for government intervention. Capital owners should not be allowed to socialise their losses; and workers, if they are laid off, would find employment elsewhere, albeit at lower wages. Although this view may be, by and large, correct in principle, there are two reasons why it can and perhaps even should not always be applied to reality. The first is of a theoretical and the second of a political nature.

IV. Market Ideology versus Political Reality

To the extent that the arguments against government intervention are based on simple "textbook economics", thought needs to be given to the reality content of the assumptions underlying the reasoning. Simple textbook theory takes it for granted that structural adjustment is continuous, incremental and frictionless. Everything, including plant capacity, is indefinitely divisible. There are no rigidities, - neither natural nor man-made. Delayed adjustment practically does not occur. And if there are adjustment costs at all, they can never be excessive. Unfortunately, it seems that this is not the real world.

The second line of argument adds a further dimension, - and this concerns the political economy associated with structural adjustment. Apart from the fact that economic efficiency is not the only objective of policy, governments are confronted with important asymmetries in terms of the visibility of the effects of their policies. This is particularly evident with respect to the social benefits and costs of trade liberalisation.

The benefits of the opening of domestic markets to foreign competition and associated structural adjustment, such as the positive growth and productivity effects and the contribution to combat inflation, are spread thinly all over the economy and frequently not very visible. Also the shift of resources to activities with higher value added and the creation of more competitive new jobs are not normally directly attributed to such policies. Yet the costs of trade liberalisation and subsequent structural change, in particular the jobs lost in internationally non-competitive industries or companies, are extremely eye-catching. There is little doubt that this can easily introduce a defensive and protectionist bias into government policy towards structural adjustment, in particular if the supportive parliamentary majority is relatively small or the next elections are all too near.

Finally, it is important to underline that economic efficiency is not the only objective of government policies. If the industry in difficulties is the only major employer in a peripheral region, governments are normally tempted to support the enterprises in question, - for political and social reasons and also in the interest of more balanced regional development. The preservation of the environment or the protection of national or regional cultural identity are other aims which, in certain cases, may provide policymakers with difficult choices if, in principle, their goal is to ensure highest possible economic efficiency in the framework of a competitive market economy.

V. Criteria and Policy Implementation Rules for Government Interventions in the Light of Structural Crisis.

If a country has taken the principle decision in favour of a market economy for its economic order, the point of departure for establishing rules for government intervention is very much in line with the views of the advocates of the pure market orthodoxy. This means that there should be as much market co-ordination as possible, and no more government intervention than necessary. Although the dividing line where the possibility for markets to operate freely ends and where the necessity for governments to intervene begins, is not defined, this is not an empty formula.

It establishes clearly that whoever wants government to come in, has to prove either that there is, or will be, a major violation of non-economic objectives or that there is substantial present or foreseeable market failure. In addition, the supporters of government intervention have to produce evidence that the result of such action is superior to the expected outcome of market co-ordination. Indeed, it is not at all advisable to just replace market failure by government failure.

If governments were to already adhere to this principle, many instances of major market distortions caused by activist policymakers would be avoided. In the context of structural change, industrial decline and the possibility of excessive adjustment costs the above argumentation has however to be pushed somewhat further. In particular three issues have to be discussed: first, what does "excessive" adjustment costs mean? ; second, how can they be measured? and third, what is the time-horizon of the analysis?

The response to the last question is the easiest. In principle, the time-horizon is indefinite; however, for practical purposes it appears reasonable to look at least at the medium term. In most instances, this means 5-10 years. To provide the answer to the second question is already slightly more difficult, but in general terms, the response is clear. The basic requirement would be independent analysis and an absolutely transparent approach not only to the costs, but also to the benefits of the adjustment process. Of course, this can involve major difficulties with respect to data availability, the quantification of the non-economic implications and the choice of methodology. Nevertheless, even very rough estimates can be very helpful in the decision-making process, in particular as they force participating actors to make explicit the basis of their own evaluation.

The real issue is then to find the answer to the first question, and without doubt, determining what in terms of adjustment costs should be considered excessive, remains basically a political judgement. However, even in this context the evaluation may generate very different results depending on whether the balance between benefits and costs is found to be unacceptable from an overall political, economic and social perspective, or whether the results of structural change are judged acceptable or even desirable in general, but not in terms of their regional or social distribution. In the latter situation the final decision may well be, not to impede or delay the market induced structural adjustment but to compensate the losers in this process at least partially through different approaches. Government aid for training and re-skilling, special placement programmes and/or income support may be in many cases by far a better choice than outright support measures for the industry in difficulties.

VI. Intervention Principles in the Case of Proven Systemic Risks

In exceptional cases, independent analysis may support the view that the net social costs of market induced stuctural adjustment are indeed excessive, and that the balance between benefits and costs could be markedly improved, – not only through the indirect measures mentioned in the previous section of this paper, but through direct aid to the industry in question. Such a situation can arise when industrial decline is extremely rapid, involves major plant closures, leads to lay-offs in great numbers and implies considerable sectoral and/or regional spill-over effects.

In this case, governments have three options. First, they can provide support to investment in new product or process technology or in capital equipment needed to rejuvenate the industry. This would be in line with long-term growth and positive structural adjustment when after such measures the industry can indeed regain genuine competitiveness in international markets. The second option, sometimes in combination with the first, is government assistance for profound restructuring. This could involve revitalisation of some parts, sell-off of others and closure of the rest. The third variant would be that governments soften too rapid a decline in order to allow for orderly closure.

In any event, what must be ensured is that government assistance definitely contributes to adjustment. It should not be taken as a source of rent, - neither by entrepreneurs and capital owners as a source of windfall profits - nor by the workers and unions as an opportunity to appropriate part of this aid to unwarranted high wages. It is indispensable therefore that supportive government interventions be absolutely transparent and at the same time be made subject to clear and binding conditions and criteria.

Most importantly, action must be temporary, wherever possible, reduced progressively according to a predetermined timetable, and firmly coupled with explicit conditions for effective restructuring or closure. In addition, and whenever the attempt is made to rescue an industry or major company, preference should be given to such forms of government aid that allow, to the greatest extent possible, the continued play of market forces. In particular, this would include maintaining the rigorous scrutiny of capital markets and therefore stipulating that private risk capital always participate in such operations.

If private investors, and especially private banks, do not see the prospect of a successful conclusion of the restructuring project, governments should definitely refrain from passing taxpayers' money on to inefficient producers and ailing industries and companies. In this situation the only remaining option is orderly closure and softening the systemic repercussions through indirect and horizontal measures. This would include government actions in particular on three fronts: first, measures which help to improve the general economic climate for entrepreneurship, investment and innovation. Second, measures which enhance the employability of laid-off workers and attenuate their burden for an interim period. And third, especially if there is a specific regional problem, to provide temporary incentives which attract new companies with the aim of economically revitalising the most hard-hit locations.

<u>A final remark</u>: Innovation and competition and, associated with them, structural change always produce winners and losers. Prospective losers will always seek to slow down the adjustment process, and sometimes they may even try to substantiate their attitude with the allusion to possible systemic risks. Yet, governments are responsible for the common good and they should never forget in this context that: There is hardly any economic and social progress without structural change, and adjustment costs are a normal side-effect. Furthermore and most importantly, both empirical evidence and theory affirm as a rule with very, very few exceptions that : Delayed structural adjustment is the most costly adjustment of all.

Structural Adjustment and Systemic Risk: Financial Sector Issues

Caroline Atkinson
Senior Fellow
International Economics, Council on Foreign Relations,
Former Senior Advisor to the US Secretary of Treasury

Introduction

First, may I thank the Korean Ministry of Foreign Affairs and Trade, the Korean Institute for International Economic Policy and the OECD for hosting this excellent conference and for inviting me to speak at this important session. The topic of this session — structural adjustments and systemic risks — is of utmost importance to Korea, and also has relevance for other countries. I intend to concentrate in my remarks on the financial sector aspects of this issue, as Mr Michalski has covered issues affecting the non-financial or corporate sector.

I would like to say a word at the outset to explain my own interest and involvement in this topic. From May 1997 until earlier this year, I was in the international department of the US Treasury. In that position, I was very concerned with the "Asian crisis," and its systemic implications. From 1998, I had particular responsibility for the topic called "reform of the international architecture."

This effort aimed at reaching international agreement among a wide group of countries — including Korea — on ways both to minimize the likelihood of future financial crises and to reduce the severity and depth of those that did occur. In this work, we were constantly aware of the tension that can arise between addressing a potentially systemic problem — or managing a crisis — and the danger that steps to deal with the crisis could, if badly executed, increase the likelihood of further crisis in the future by encouraging "moral hazard". This occurs when people, governments, or institutions engage in more risky financial behavior than they would otherwise because of a belief that they will be "bailed out" and so will not have to bear the full costs of their actions.

BACKGROUND

The past four years have been a period of tremendous change in Korea, as well as in the region, following the financial crisis of 1997-98. Structural reforms in both the financial and the corporate sector have been at the heart of the change, as structural rigidities and inefficiencies in the previous relations between financial firms and corporations were widely viewed as a main factor contributing to the crisis. In particular, the high degree of leverage of Korean corporations, the dominance of large chaebol that had long been considered too big to fail, the lack of a credit culture in the banking system, the important guiding role of government – characterized by the system of "directed lending"-- and the interconnections of companies and banks have all been blamed for the depth and severity of the financial collapse in 1997-98 and decline in output that resulted.

Korea made an impressive and swift recovery from crisis, although there has been a renewed slowdown in growth this year. As a number of papers and reports have documented, its performance under the program agreed with the IMF was very strong. Moreover, policy was characterized by the implementation of important reforms in the financial and corporate sectors, as well as the more traditional macroeconomic areas that countries address with IMF programs. In particular, enormous steps have been taken to "clean up" the financial system and reduce bad loans, to introduce a stronger supervisory and regulatory system and to promote better risk management and credit decisions by banks and other financial institutions. But the process of structural reform is inevitably a long and difficult one. Moreover, the switch from one model of corporate and financial behavior to another, more market-based model raises a host of questions.

One of the most important questions is how and where to draw the line on the role of government in a market-based model. Since the 1997 financial crisis, Korea has been faced with a particular dilemma. Policies of structural reform have been aimed at reducing the role of government in the economy, establishing the regulatory and legal infrastructure for a modern market economy and then promoting efficient behavior by economic agents by increasingly allowing the market rather than government to determine winners and losers, and letting prices rather than government direction be the guide for producers, savers, and investors. These reforms are needed to strengthen the resilience of the financial sector, and the economy more generally, and thus reduce the risk of future crisis.

But at the same time, the role of government in the economy has by some measures increased dramatically, as a direct result of the emergency steps to stem financial crisis. The government has put a substantial amount of money into recapitalizing the banking system, has bought an overwhelming amount of non-performing assets, and more recently has sponsored a support operation for the corporate bond market.

These moves have generally been supported by the IMF, the OECD and others as necessary steps to forestall systemic risk and lay the foundation for growth and economic recovery. Without the government support for the financial system, there was a real danger of a spreading collapse of the banks and other financial institutions that provide the essential lubrication of a modern economy, with consequent huge losses to the real economy. However they naturally raise the question of when government intervention is necessary and desirable because of systemic risk, and when is it excessive and even a potential cause of future systemic risk.

COUNTRY EXPERIENCE

Korea is not the only country to face such a question. Banking and financial crises that have tested governments have occurred in countries as diverse as the United States, Finland, Mexico, Sweden, Japan and others. Experience in these cases has indicated yet a further issue of tension between systemic risk and structural reform. When systemic crisis threatens, it is tempting for policymakers to avoid any actions that could precipitate the crisis that threatens, and to support short-term measures to postpone crisis.

Hence, at times of stress in the banking system, there is usually some support for regulatory forbearance. This forbearance is aimed to cushion the immediate shock of financial stress and may take different forms, such as allowing banks more time to recognize their losses, write down capital and then take steps to restore capital/asset ratios. At times of more general financial and business difficulties, there is usually similar pressure for postponement of structural reforms in the corporate sector and provision of finance and liquidity to avoid bankruptcy and losses.

Unfortunately, while these pressures are understandable, country experiences show that delays in addressing problems of a potentially systemic kind tend to worsen, rather than ameliorate, the underlying difficulty. The eventual adjustment is often more costly as a result.

In the United States, it took several years of the Savings and Loan crisis before resolution was finally decided upon and executed. For a number of years, regulators and policymakers were reluctant to force institutions to close or loans to be sold at a loss. They hoped that housing market conditions would improve, enabling losses to be recouped, and feared that forced disposal would worsen conditions in the housing market and be costly to the tax payer.

However, this policy encouraged the weak institutions to “gamble” for survival, and led to a long period where the real estate market did not function well as there was an overhang of potential, but unrealized, sales and defaults casting a shadow on market prices. The resulting cost of the crisis when it was finally faced, with loans written down and sold, and failing institutions closed, was considerably more than it would have been some years earlier. This in turn prompted reform in the bank regulatory system, with Congress insisting (in the 1991 FDIC Reform Act, FDICIA) on steps to circumscribe the power of regulators to allow weak or ailing banks to delay what is called “prompt corrective action” to restore their health.

Attempting to combat what one economist has called “bureaucratic tendencies toward forbearance and postponement,” the legislation instituted a scheme of statutorily-mandated prompt corrective actions, that would be triggered as banks’ capital diminished, forcing recognition of loss and a swifter move to force the exit of failing institutions. The Federal Deposit Insurance Corporation, was also enjoined to use the least costly measure of meeting its insurance obligation, and not to protect creditors or uninsured depositors if that would increase its losses. As KAMCO has discovered in Korea, imaginative and determined efforts to realize value from impaired banking assets can yield considerable return.

In Japan, few people would claim to know how best to promote economic and financial recovery in today’s circumstances. But most would agree that it was a serious and costly mistake to avoid for many years acknowledging losses from bad loans on banks’ balance sheets, and addressing these through restructuring, exit of non-viable institutions, recapitalization and so on. In Korea, I believe that there has been growing recognition of the importance of addressing effectively the problem of the investment trust companies, and growing evidence that attempts to use government intervention to shield the economy from the full impact of over-borrowing by still troubled corporates carry important dangers.

It seems that a general lesson that has been learnt in different countries by different regulators is that as long as the underlying problems that have led to financial sector stress are not dealt with, delay and forbearance is likely to do little more than allow weak institutions more time to build up even larger losses.

What is systemic risk?

A few commentators conclude from this experience that governments and regulators should intervene less, rather than more, to allow the market and prices to work most efficiently. At the extreme, some even argue that there should be no deposit insurance or government regulation or intervention at all: the markets could do it better. However, most recognize that there are genuine dangers from systemic risk, and that it is part of the responsibility of government to do what it can to reduce these.

At the same time, the public sector needs to structure its intervention so as to foster market forces, rather than inhibit them, and to strengthen the market infrastructure within which the private sector operates. The key is to provide incentives and a framework for the private sector to use market forces to become more efficient, better able to judge and manage risk, and thus better at avoiding excessive risk taking. It is, of course, easier to do this in periods of calm, but it is also important not to undermine the market at times of crisis.

A first issue for those wondering how and when to let market forces operate fully, and when to intervene to forestall systemic risk, is that there is not a single, simple definition. Most discussions of systemic risk focus on the banking system, rather than the financial system or economy more broadly. This reflects both the peculiar vulnerability of banks, whose assets are long-term but whose liabilities are typically very short-term, and also their key role in the functioning of a modern economy through their part in the payments system.

I believe that a broader definition of systemic risk is helpful both to understand what governments do in practice in times of financial crisis, and what they should do. The Group of Ten officials from Finance Ministries and Central Banks in (actually elevent) major industrialized countries touched upon systemic risk in a major report on financial consolidation issued at the beginning of this year. Their “working definition of systemic risk” consisted of two parts: the risk of financial difficulties spreading beyond an initial locus in one institution or market, and the likelihood that such difficulties would in turn have a severe impact on the real economy.

Looking at the first part of systemic risk, the systemic danger arises because of the possibility of “negative externalities” or contagion within the financial system. This contagion means that crisis or difficulty in one financial institution can cause a shock to confidence that spreads difficulties to other institutions, even when these have not been in trouble before. Thus if one bank is unable to pay its obligations, this can quickly cause others that were relying on its payments to become illiquid in turn. The possibility of depositor runs means that any threat to confidence can turn into a liquidity crisis. In turn, the highly leveraged nature of banks and the fact that their assets are typically illiquid and hard to price means that a liquidity crisis can quickly turn into a solvency crisis.

Traditionally, attention has focussed on the danger in the financial system of a problem in one bank cascading into problems for others, given the tight interconnectedness of the banking system. As Sir Edward George, Governor of the Bank of England, has remarked, banks are like mountaineers: if one slips it can bring down the others that are tied to it as they climb up the mountain. More recently, as financial markets more broadly have become larger and more integrated, analysts have identified the potential systemic danger that failure of one, or a few, financial institutions could damage the smooth functioning or viability of markets more broadly if they are sufficiently large players in these markets.

It was concerns of this kind that motivated the actions to promote creditor coordination to resolve the difficulties of the hedge fund Long Term Capital Management in 1998. In this sense, governments concerned to promote financial stability may widen their interest beyond the banking system itself. In a different arena — that of countries rather than financial institutions at risk — it is contagion concerns that often prompt the International Monetary Fund and its constituent governments to provide large-scale financial support to countries in financial difficulty.

In all these cases, it is the *external* cost, when failure spreads from one firm to another, or one market to another, which gives rise to a case for public intervention. The public has an interest in the health and viability of the financial system as a whole, and in the steady operation of financial markets overall, even if the health of an individual institution on its own is a matter of private rather than public concern.

This leads to the second part of systemic risk: that financial disruptions, to be considered systemic, must have potentially large and undesirable effects on the real economy. In other words, a systemic threat is one that threatens production and employment in the economy as a whole. Such adverse real effects from financial shocks typically come from disruptions to the payments system; from impacts on credit flows (e.g. a credit crunch arising from banking difficulties could severely reduce the ability of otherwise solvent firms to borrow and operate); and from wealth losses if asset prices decline or if savings held in failing banks are essentially lost.

As Korea has unfortunately experienced at first hand, all of these can have a severe impact on the real output of goods and services and on employment: primary and legitimate concerns of economic policymakers and their constituents. Moreover, if financial instability is allowed to persist or increase, there can be a snowballing effect on the real economy. A banking crisis, in particular in a country where the bulk of credit intermediation is through the banking system and where many households have their wealth deposited in banks, can quickly feed through to a major economic crisis.

Criteria for Intervention

There is therefore a fairly straightforward case for government intervention in the financial system in periods of great stress. In extreme cases, government takeover of institutions — effectively nationalizing banks — can be justified. In Korea, and some other Asian countries during the crisis, the overall banking system was so weak, and the available capital to meet losses so inadequate, that such government intervention was the only alternative to extremely severe economic problems. However, there is considerable room for uncertainty about just what constitutes a systemic threat.

Interestingly, views about the appropriate point at which governments should intervene have also shifted over time. A clear example of this came in 1995 when the long-established British bank, Barings, was allowed to fail after devastating losses run up by a "rogue trader" were uncovered that far exceeded the bank's capital. Some hundred years earlier, Barings had again been in trouble but at that time had been rescued without question.

In Japan, for many years the "convoy" system operated so that stronger banks supported the weaker ones. It was felt that failure of an internationally active top tier bank would be devastated. However, after the Asian crisis, the costs of this policy became more extreme. The persistence of a Japan premium in financial markets; growing evidence that some banks were simply not going to grow out of their problems; a slow shift towards more transparent accounting that made losses harder to conceal; and, finally, concern that the attempt to keep weaker banks afloat might lead instead to their bringing down the stronger institutions all helped to persuade the authorities to allow a few banks to fail and merge in the late 1990s. Of course, there is still a very long way to go before the needed structural reforms in Japan's banking system have been made.

In the US, the legislation that I mentioned above, and the experience that led to it, have also changed expectations about the scope of likely government intervention in time of crisis. In particular the constraints on regulatory action to support weak banks are considerable. There is an exception to these constraints in cases of systemic risk. However, it is drafted to limit its use to truly exceptional circumstances. The legislation does not try to define systemic risk. Instead, the use of this exception is subject to conditions that would tend to discourage its use. In order to invoke the clause, the FDIC must have the agreement in writing of two-thirds of the Federal Reserve and the Secretary of the Treasury, who in turn must consult the President. Any additional losses must then be recouped by a special assessment on the banking industry.

Since systemic risk involves a large shock, some have argued (or assumed) that some institutions are simply too big to fail. But most regulators would strongly resist acknowledging this criterion or, at the least, defining the institutions that would be included in it. Why not be explicit about the extent of the government safety net for financial institutions? The argument is that an explicit recognition of which institutions would be kept open would be an invitation to those institutions to act unwisely. It would also undermine the discipline that the market imposes on banks to behave prudently if large depositors and creditors (not to mention shareholders) believed the government would always bail them out.

There is also the fact that a bank failure which could deliver a very serious shock to the real economy in certain circumstances — for example if there was a lot of leverage in the system and the economy was in a downturn — would be manageable in other circumstances. Part of the concern about both LTCM and Brazil in the second half of 1998, that encouraged some indirect and direct government help to resist collapse in one and devaluation/default by the other, was that financial markets were already stressed and fragile.

Conclusions and Issues for Discussion

I would like to draw only brief conclusions, to give scope for some discussion.

Firstly, there is clearly a case for government intervention to avoid systemic risk from banking collapse in some circumstances. But, secondly, such intervention should work with and not against the market.

It is important for government to act quickly to stop banks and other financial institutions from making new bad loans when their capital base is already threatened. Action to reduce systemic risk should be aimed at protecting the financial system and the economy as a whole, not at saving particular institutions. Whereever possible, shareholders should bear losses before the taxpayer shoulders them, and old managements that have failed should be replaced with new ones.

A further point is that at times of crisis, it is better to seek the greatest information and transparency—for both policymakers and the markets. If a decision is taken to support an institution, it should be based on a true assessment of likely losses.

Finally, one important tool to reduce potential systemic risk in the banking system is deposit insurance. This will work most effectively with two conditions. The first is that there should be some form of graduated or limited coverage, so that large depositors have an incentive to exercise due diligence over the bank and demand appropriate interest rates for the level of risk. Secondly, such insurance will be most effective in stopping runs and limiting systemic risk if it is paid out immediately and unconditionally on the basis of previously agreed terms.

Thank you

Korea's Financial Reform: A Systemic Risk Approach

Jang-Yung Lee
Senior Counselor to the Deputy Prime Minister
Ministry of Finance and Economy

I. Introduction

By now, it is almost a consensus view that Korea has made remarkable progress in the post-crisis economic adjustment program of the last four years. Macroeconomic fundamentals have improved and external vulnerability has been sharply reduced. A wide range of structural reforms has properly addressed pre-crisis weaknesses in the financial, corporate, labor, and public sectors. Particularly good progress has been made in financial sector reform and restructuring, thus restoring its soundness and profitability.

However, the recent IMF annual mission points out that continued restructuring is imperative to reduce the vulnerabilities that arise from the weak corporate sector. More recently, the OECD country report of 2001 gave out a warning that there is still a risk of major failures in Korea's business sector, especially with the economic downturn likely to exacerbate corporate balance-sheet problems.

How should we interprete these negative assessments made by refutable IFIs? What are the lessons to be drawn from Korea's post-crisis economic reforms? Were the sequence and pace of the structural reforms appropriate in light of the nature of the crisis and special situations faced by the Korean economy?

The purpose of this paper is to seek answers to these questions by evaluating the post-crisis reforms in Korea with a special emphasis on the financial sector reforms.

On the surface, it is fairly clear that the speed of corporate restructuring was rather slow relative to the financial sector reform. And there is a widespread recognition that further delays in tackling the corporate sector problems will make matters worse with serious systemic ramification.

But, more analytically, we should examine whether Korea's initial strategy and policy responses were properly formulated to address the systemic risks faced by the financial system as well as the economy in general. We also need to evaluate the seriousness of systemic threat, if any, currently posed by the presence of chronically insolvent companies in Korean economy.

II. Financial Restructuring: A Systemic Risk Approach

Designing a financial sector restructuring program in the midst of a crisis of confidence is obviously very difficult, requiring both emergency measures that can maintain the stability of financial markets and a more comprehensive resolution strategy for ailing financial institutions.

In Korea, as the results of the diagnostic review for financial institutions were not readily available, the first choice was made to provide a temporary blanket guarantee to protect all depositors of the financial institutions. The government had to this initiative to maintain public confidence in the banking system in the wake of the financial crisis at end-1997. Other crisis-hit Asian countries (Indonesia, Thailand, Malaysia) also introduced the blanket guarantee as an indispensable instrument to deal with the banking sector turmoil.[34]

However, the stability of Korea's financial markets has not returned until mid-1998, when the IMF and the Korean authorities agreed on a comprehensive financial reform program including the establishment of the necessary infrastructure and resources to support the financial restructuring process. They decided to make the Financial Supervisory Commission (FSC) operational, reorganize the Korea Asset Management Corporation (KAMCO) as a bad bank, and secured the National Assembly's approval on the W 64 trillion (15 percent of GDP) of public funds for financial sector restructuring.

Fiscal support of the financial restructuring was justified as the government regarded the financial sector soundness as a *public good*. However, in order to minimize the use of the funds and to prevent moral hazard problem, the public support was provided only to the extent necessary to facilitate restructuring and conditional on self-rescue efforts on the part of the recipients.

The government also applied a *differentiated approach* based on the systemic importance of the financial institutions, starting with the most serious problems. This implied that the priority of the government-led financial restructuring was given to the deposit-taking institutions such as commercial banks, as unsound banks posed a greater *systemic risk* to the nation's payment system[35]. Like in other crisis-hit countries, restoring the viability of the banking system was one of the important objectives of the restructuring strategy as it can mobilize financial savings and ensure essential credit flows to the economy. Once the banking sector problems are dealt with, the focus would shift to the non-bank financial institutions.

Within the banking sector, the government tried to confine the availability of public funds to those financial institutions with the greatest *systemic importance.*

Soon after the crisis erupted, the Korean government worked jointly with the teams from the IMF, the World Bank, and the Asian Development Bank to examine the financial health of the banking institutions. Of the 26 commercial banks, two *systemically important* banks (Korea First

---

34 Philippines did not introduce the blanket guarantee, because the country did not experience a full-blown crisis and had a well-established deposit insurance scheme.

35 The commercial banks were holding 51.2% of total assets in the financial system at the end of 1997.

Bank and Seoul Bank) were found to be technically insolvent. So, before deposit flights to quality banks occurred, the two banks were quickly recapitalized and taken over by the government.

In addition, five small- and medium-sized banks with negative capital ratios were closed with their assets and liabilities transferred to five stronger banks under the purchase and assumption (P&A) agreements. The government provided the public funds to the acquiring banks to compensate for the negative net worth of the acquired banks. This was followed by the injection of substantial public funds into the banking system for the recapitalization of weak banks, loss coverage, and depositor protection by the Korea Deposit Insurance Corporation (KDIC) as well as the purchase of non-performing assets by the Korea Asset Management Company (KAMCO).

It is interesting to note here that the speed of bank recapitalization in Korea was relatively swift compared with other crisis-hit countries, as Korea's bank restructuring strategy emphasized the strengthening of prudential regulations in the short run, particularly the minimum capital adequacy requirements. For example, the commercial banks were required to meet a capital adequacy ratio of 6 percent by March 1999 and 8 percent by March 2000, in full compliance with international standards in asset classification and loan-loss provisioning.[36]

The cost of financial restructuring was high and largely fell on the public sector. As seen from the table below, as of end-June 2001, the gross injection of public funds amounted to W 137.5 trillion (26 percent of 2000 GDP).[37].

Of these, the banking sector has received W 81.5 trillion of public funds (59.3 percent of total public funds). And, while W 53,7 trillion was injected into the non-banking sector, pure non-bank, non-depository institutions (such as securities and investment trust companies) have received only W 16.0 trillion (11.5 percent of total public funds).

36 By contrast, Indonesia's banks were required to meet the 8 percent capital adequacy ratio by the end of 2001.

37 Gross cost of financial restructuring is estimated to be 45 percent and 12 percent of GDP in Indonesia and Malaysia, respectively

Table 1. Use of Public Funds in Financial Sector Restructuring

(In trillions of won)

	Re-Capitalization	Deposit Repayment	Asset Buy	NPL Buy	Total	
					Amount	%
Banks	44.3	-	13.2	24.0	**81.5**	59.3
Non-banks						
Securities& ITCs	7.7	0.01	-	8.3	16.0	11.5
Insurance	10.4	-	0.4	1.8	12.6	9.2
Companies	2.7	12.2	–	1.6	16.5	12.0
Merchant Banks	0.05	5.8	0.5	0.2	6.6	4.8
Mutual Savings	-	2.0	–	–	2.0	1.5
Credit Unions	20.9	20.0	0.9	11.9	**53.7**	39.0
Sub Total						
Offshore Institutions	-	-	-	2.3	2.3	1.7
Total	**65.2**	20.0	14.1	38.2	**137.5**	100

Source: Ministry of Finance and Economy, Public Fund Management Committee (August 2001), *White Paper on Public Fund Management*

The W 65 trillion worth (47.4 percent of total public funds) of public funds were spent for recapitalization purpose. However, the government provided little to recapitalize weak merchant banking sector, primarily because the sector was not systemically important.[38] Merchant banking sector held only 5.8% of the nation's total financial assets at end-1997. As a consequence, as many as 21 out of 30 merchant banks were liquidated or merged with others. And, the government had to inject W 12 trillion of public funds for the deposit repayment to the customers of the failing merchant banks, since their deposits were fully protected by the blanket guarantee system.

Korea's financial reform also entailed a significant consolidation of other non-bank, non-depository institutions, such as the investment trust companies (ITCs). This type of financial institution had been investing capital raised from retail and institutional investors in stocks, bonds, and short-term money market funds.

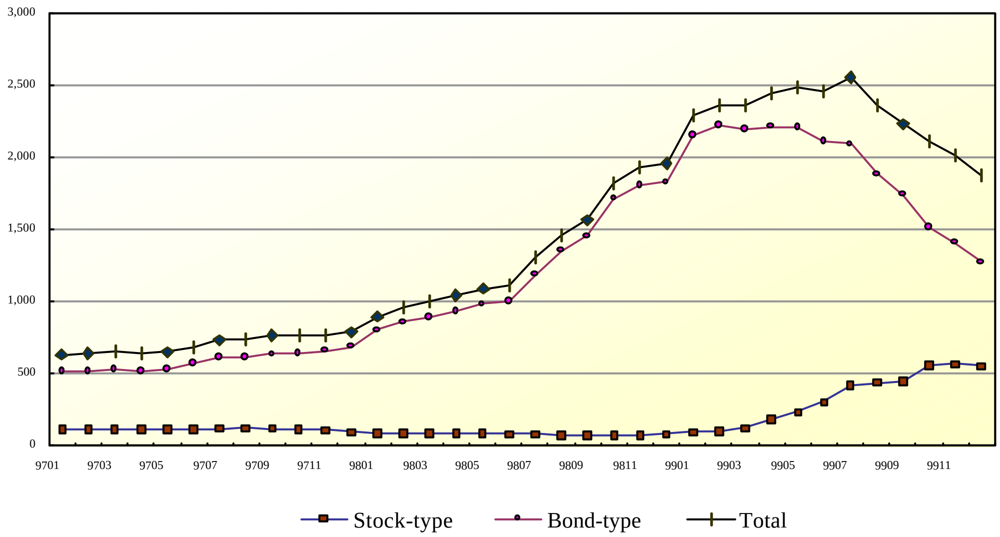
At the outset, the government did not pay much attention to the potential problems in the ITCs, because this sector did not show the characteristics of a systemic crisis, at least in the initial stage of the crisis.[39]

On the contrary, there has been a boom, albeit temporary, in the ITC industry. During the period between end-1997 and mid-1999, the total assets of the ITCs have increased dramatically from W 84 trillion to W 251 trillion, driven in part by the sharp reduction in interest rates and in part by relatively lax financial supervision as compared with that of the banking sector.

38 Another reason was the fact that most of the merchant banks were owned by large conglomerates called chaebols.

39 Another reason why the government underestimated the problems in the ITC industry was that the accounting and disclosure standards at the ITCs were very poor, thus helping to hide the true size the potential problems.

Figure 1. Trust Assets of Investment Trust Companies
(Unit: W billion)



However, the environment rapidly began to deteriorate in July of 1999, when the extent of Daewoo's debt problems became widely known to the investors. Public confidence in the ITC industry was severely damaged when they found out that more than 80 percent of domestic bonds and commercial paper issued by Korea's second largest conglomerate was held by the ITCs.[40]

Being skeptical about the ability of Daewoo to meet its debt obligations, the concerned investors withdrew their money from the ITC. Amid rumors that most of the ITCs were insolvent, the fund runs multiplied soon and the unprecedented redemption pressure appeared to be unmanageable.

To deal with this systemic crisis, the government took a number of steps, including (i) restrictions on the ITC fund redemptions, (ii) creation of a bond market stabilization fund to purchase bonds, (iii) and an injection of W 3 trillion in public funds to rehabilitate the two largest institutions in the industry—i.e., Korea ITC and Daehan ITC.

The redemption pressure on the bond funds slowed, and corporate bond rates have come down immediately after the implementation of these measures.

However, the government has been criticized for taking these measures, which could be seen as inconsistent with the goal of market-friendly reforms. Some noted that the government should refrain from injecting the public funds to the ITCs, on the grounds that they are not deposit-taking financial institutions and thus do not threaten the functioning of the payment system.

40 The amount of Daewoo-related debts held by the ITCs was about W 27 trillion, which represented 10.9 percent of total money in trust at the ITCs.

Despite the use of non-traditional policy instruments, the government's intention was not to be intrusive in its involvement. Based on the market's failure to respond appropriately to financial sector distress and its possible systemic consequences, the government had to provide temporary liquidity support. Here, for accurate evaluation of the policy, we need to use a more precise definition of systemic risk.

As an important criteria for the determination of financial policy stance, the systemic risk denotes either an *event risk* or a *refinancing risk* that potentially paralyzes a significant portion of financial market or economy-wide flow of funds. The event risk may arise when a large company suddenly goes into bankruptcy, while the refinancing risk can be triggered by a rapid deterioration of creditworthiness on the part of the corporate borrower or a heavy concentration of maturing debts.

Based on these notions, the collapse of the Daewoo and the systemic effect from the distressed investment trust industry can be classified as an event risk. Therefore, in light of its implications for systemic risk, the government's strategy to address the immediate liquidity crisis in the ITC sector is well justified, though it may compromise in the long run the incentives for effective market discipline.

Asymmetric restructuring strategy

Despite the positive tone of the above discussions, some point out that the government's strategy for the restructuring of the financial sector leaves many things to be desired.

First, some note that the government's strategy to prioritize the restructuring of banks and merchant banks did not improve the overall risk of the financial system, insofar as the weaknesses in the non-bank financial sector were not properly addressed. And this asymmetric approach had the effect of lengthening the period of corporate and financial restructuring. [41]

It is true that some of the large companies (such as Daewoo and Hyundai) could continue to finance their investment during the period of financial crisis, as the funds were shifted from the banking sector, over which regulations was strengthened, to the non-banking sector which remained poorly regulated.

However, it is not clear how big the artificial incentives were for the non-banking sector's expansion created by the differential regulatory framework. If anything, the exceptional growth of the trust assets at the ITCs has been driven more by the sharp reduction in interest rates in the latter half of 1998. The substantial capital gains earned on the existing bond holdings allowed the ITCs to mobilize huge investments by offering very attractive rates of return.

Another positive aspect of the asymmetric approach to Korea's financial restructuring is the mitigation of the impact of a "credit crunch" on the financial situation of the corporate sector. Banks have shown a more conservative attitude to lending to the corporate sector since the crisis of 1997, due mostly to the deteriorating economic environment and the growing awareness of the

41 See Yoon Je Cho (2001) for details.

importance of BIS capital adequacy ratios. So, the banks cut back on their lending between end-1997 and mid-1999, while the expansion of the non-banking institutions such as ITCs filled the gap in overall financial intermediation activities.

However, the financial intermediary functions of investment trust weakened greatly in mid-1999, when there was a renewed corporate bankruptcies associated with Daewoo's work-out. For example, the default rate of corporate promissory notes rose sharply from 0.1 percent in January 1999 to 1.12 percent in August 1999.

Pace of Corporate Sector Restructuring

Recognizing that the health of the financial sector and the profitability of the corporate sector are closely linked, Korea has pursued the financial and corporate sector restructuring simultaneously. However, many observers point out that actual pace of the corporate sector restructuring has been relatively slow as compared with that of the financial sector reforms. Progress has been slow in resolving non-viable companies, and as late as mid-2001, some of the affiliates of medium-sized *chaebols* were close to insolvency, increasing risk in the banking sector.

It is true that the rapid recovery of 1999-2000 has led to a sense of complacency and accordingly weakened political support for many tough reform measures. However, the main reasons why the corporate restructuring lagged behind include: (1) weak accounting and disclosure standards, (2) poor risk management in both corporate borrowers and the banks, (3) and inadequate legal and judiciary framework governing insolvency procedures, at the onset of the crisis.

The weak accounting practices undermined the credibility of company reports and made the creditors' assessment of the corporate sector health very difficult. In addition, the long-standing practices of the collateral-based lending and poor disclosure of cross-payment and cross-guarantees among affiliates of *chaebols*, have made it almost impossible for the banks to evaluate the true size of the non-performing loans in a timely manner.

By February of 2001, the government has put in place a basic framework of a market-driven restructuring system, whereby market forces monitor the viability of weak companies and weed out non-viable companies in an efficient manner. However, given the lack of risk management skills in both corporate borrowers and in the banks, Korea's approach (so-called *London approach*) of making banks responsible for restructuring troubled companies was bound to be difficult and time consuming.[42] Korean creditors were beginning to take a tougher attitude toward weak companies, forcing some important ones into bankruptcy only in 2000, when the new "forward-looking-criteria" principles for loan classification and loss provisioning were introduced.

Last but not least, the bankruptcy laws including the procedures for court-supervised insolvency have not been very effective in resolving the firms in deep distress. With the exception of the early large cases, relatively few large firms have emerged from court-supervised

42 Thailand and Indonesia also pursued corporate restructuring along the lines of the London approach. See the IMF (1999) for details.

reorganization or liquidated, suggesting that weak companies could continue to operate under the court's protection.

Corporate restructuring using an out-of-court workout framework was not so effective either, partly because the government-led restructuring process was increasingly replaced by the market-driven mode, and because, under the old rules for loan classification, Korean banks were allowed some regulatory forbearance. Since the banks could classify restructured loans as "precautionary" involving only modest loss provisioning, they preferred to restructure debt by reducing interest rates or extending maturity rather than writing off debt outright. This distorted incentive structure, in turn, made Korean banks very hesitant to cast away the "zombie" companies.

Macroeconomic Vulnerability

Unlike the uneven path of structural reforms, the post-crisis macroeconomic adjustment process was rather smooth. The IMF program, which had prescribed tight fiscal and monetary policies, remained on track until second half of 1998.

Despite their contractionary impacts, those IMF-supported stabilization policies did contribute to an early restoration of investor confidence in Korean economy as well as a significant current account surplus. This, together with the successful rescheduling of external debts, led to the sharp rise in the foreign exchange reserves, which in turn has improved the nation's sovereign credit ratings.[43]

Thus, by early 1999, the country's external position has ceased to be a systemic threat to its economy. A country's macroeconomic vulnerability can be defined in many ways. However, based on the three indices of macroeconomic vulnerability-- i.e., misalignment of exchange rates, imbalance between domestic money and foreign exchange reserves, and excessive credit growth, Korean economy became free of these types of risks by early 1999. (See Appendix 1).

Once the macroeconomic stability was restored, the government's economic program adopted a more flexible position to support the incipient economic growth in 1999.

Renewed credit crunch phenomenon

The new economic team that came in August 2000 has increased its efforts to provide new impetus to reform and restructuring, as a false sense of complacency had set in after the V-shaped strong recovery of 1999-2000.

Recognizing the need to accelerate the pace of corporate restructuring, the government launched the Second Round Restructuring Plan in September 2000, which focused on a prompt settlement of nonviable firms. The government pushed creditor banks to identify 52 firms as being nonviable and designated them for court receivership or liquidation. Included in this stern

43 The official reserves have been rapidly replenished from $ 7 billion at end-1997 to reach $ 74 billion by end-1999. During the same period, the short-term external debt has shrunk from $ 63 billion to $ 37 billion, raising the ratio of short-term debt to official reserves from a mere 11 percent to 200 percent.

measure were large companies like Woobang and Dong-Ah. The resolution of these large firms in distress contributed to the shattering of the "too-big-to-fail" legacy.

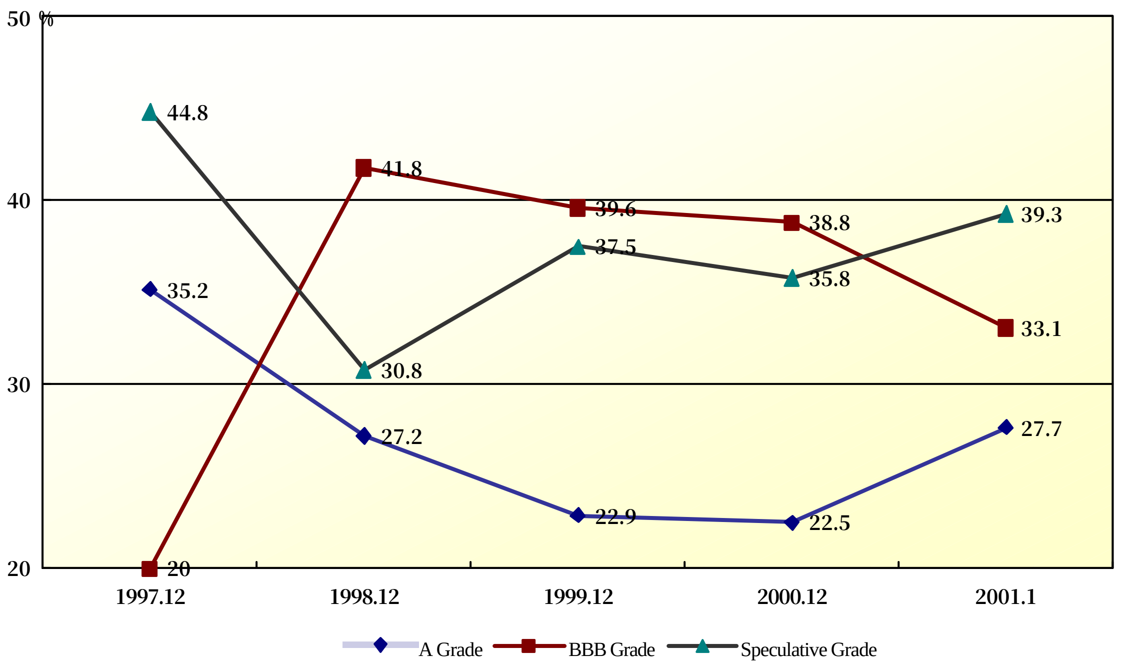
Toward the end of 2000, however, an issue of policy concern emerged: A massive amount of corporate bonds that had been issued between late 1997 and early 1998 were coming due in early 2000, while the corporate bond market was not functioning properly in the midst of ongoing reforms.[44]

Another factor causing the problems in the bond market was the high credit risk perceived in the corporate sector, which in turn stemmed from the economy's sharp slowdown in the second half of 2000.

Moreover, the virtual demise of the merchant banks and the shrinkage of the investment trust industry, traditionally the major investors in the corporate bonds, created a very unusual situation: a state of paralysis for the entire corporate financing function. Riskier corporate borrowers did not have any access at all to medium-term financing in the bond market. Given the absence of an active high-yield and junk bond market in Korea, a corporate bond that was not issued by a company with a rating of A or above was simply not marketable.

Figure 2. Credit Ratings of Korean Firms (Share by the Ratings)

(Unit: percentage)



44 The W 65 trillion won worth (or 13 percent of GDP 2000) of corporate bonds were coming due in the year 2001.

As shown by the above figure, the share of the speculative grade (BBB- and below) in total corporate bond fell to 30.8 percent toward the end-1998, but rose back sharply to 39.3 percent in early 2000.

The KDB's quick underwriting scheme

To ensure continued stability of the bond market and the real economy, the government announced in early January 2001 the *quick underwriting scheme*, by which the state-run Korea Development Bank would buy up to W 20 trillion (about $ 16 billion) worth of corporate bonds that face difficulty in revolving.

In a sense, it is an extended version of the existing primary collateralized bond obligation (CBO) scheme, whereby government-backed guarantee support is provided for newly issued sub-investment grade bonds. Developing the market for CBOs has been a policy priority since the Daewoo crisis of 1999 as the market can promote risk pooling and enhance bond market access for companies all across the risk spectrum.

However, the quick underwriting measure has invited many concerns and criticisms, including an argument that it goes against the market principles in that the government is effectively keeping afloat some of the large companies in distress such as Hynix Semiconductor or Hyundai Engineering and Construction (HEC). Some foreign trade officials even warned that if Korea did not stop the implementation of the quick underwriting scheme, they would bring the matter to the World Trade Organization. However, the quick underwriting measure was intended to be a temporary scheme with a window period of one year to avoid an onset of another economic upheaval.

The credit crunch problem aggravated toward the end of 2000 as other sources of financing also dried up. In addition to the bond market participants, Korean banks again became hypersensitive about the health of the corporate sector, and the degree of risk aversion increased sharply with the introduction of *partial deposit insurance* scheme in early 2001. Banks with significant asset quality problems were particularly nervous about the possible deposit flights after the removal of the blanket guarantee.

Under this circumstance, the government took on the role of a lender-of-last-resort just like any central bank's emergency liquidity support. The state-run Korea Development Bank gave temporary assistance to the companies in financial troubles without hampering the existing market forces.

One of the most important features of the quick underwriting scheme is that companies that are eligible for the KDB bond purchase are strictly limited to those that are deemed economically viable but face short-term liquidity problems. However, it is not easy to distinguish the illiquid-but-solvent firms from the illiquid-and-insolvent ones, especially when there is considerable uncertainty in the economy. Here comes the role of the creditor banks and the internationally refutable consulting companies, which jointly conduct proper solvency analyses of the companies concerned.

Another noteworthy feature of the underwriting scheme is the penalty price charged on the liquidity support. The interest rate of the acquired corporate bond is set with a spread of 260 basis points above the market rates. This penalty rate is designed to eliminate any possibility of *moral hazard*.

Lastly, the quick underwriting scheme does not take out pressure on the on-going corporate restructuring, because the benefits of this measure is tied directly to the self-rescue efforts including the asset sales and governance improvement plan. Since companies that do not show a strong willingness to carry out internal reforms are not eligible for the measure, the restructuring process will not be delayed, but rather, prompted. And, the steady implementation of the promised self-help plan is being monitored closely by the creditor banks.

Owing to the quick underwriting measure and successful resolution of a few large companies in distress (e.g., HEC and Hynix), the liquidity pressures in the corporate bond market were reduced significantly in the second quarter of 2001.

At this stage, the bond market has ceased to be a systemic concern. For example, the net issuance of corporate bonds has increased to W 5.7 trillion during the first eight months of 2001, as compared to minus W 9.1 trillion during the last four months of 2000. And though the government is strongly committed to the ending of the quick underwriting scheme by end-2001, the liquidity pressures in the corporate bond market will not likely reappear. This time, there is no bunching of maturing bonds. Furthermore, the overall size of maturing bonds with sub-investment grade (W 5.3 trillion) can be fully covered by the absorptive capacity of the primary CBO market at present state (W 6.0 trillion).

III. Corporate sector vulnerability

There is no doubt that significant accomplishment was made in Korea's corporate restructuring. The fact that 16 out of 30 top ranking conglomerates were removed from the market suggests that no chaebol is too big to fail. The average debt to equity ratio for the corporate sector declined from 336 percent in 1998 to 198 percent in the first half of 2001. Transparency and corporate governance are also improving. And in some less-distressed conglomerates, corporate divestitures and operational restructuring has taken place voluntarily.

However, the profitability of corporate sector is still constrained by the large debt burden. The decline in the debt to equity ratio was attributable more to the equity increase than to the debt reduction.[45] And, though the ratio of ordinary income to sales in manufacturing has turned positive to 1.7 in 1999 and to 1.3 in 2000, the level is much lower than other countries.[46]

The recent IMF mission points out that there still remains the large overcast of chronically distressed companies in the Korean economy.[47]

45 During the two year period between January 1999 to December 2000, total liabilities of 30 largest conglomerates has decreased by 18.9%, while their capital has increased by 79.2%.

46 The ratios for U.S. and Japanese companies were 8.6 and 2.9 in 1999, respectively.

47 See IMF (November 2001) for details.

A more complete picture of corporate health can be assessed by looking at the interest coverage ratio (ICR), which measures a firm's capacity to service its debt. The recent BOK study of 1800 manufacturing companies in the first half of 2001 found that about 29 percent still had an ICR of less than one. This implies that roughly 1 in 4 manufacturing companies are still unable to generate enough cash flow to meet their interest payments.

The discussion so far suggests that Korea's corporate sector remains vulnerable to the slowing economy, and thus calls for an acceleration of corporate restructuring targeted at nonviable firms for exit. At the same time, however, concerned policymakers should examine whether the decisive dealing with the firms in distress would pose a systemic risk to the economy.

If we define 'chronically insolvent companies' more accurately as those that cannot continuously pay financing costs out of cash income for three consecutive years, about 4 percent of Korean companies falls into this category. And the amount of total liabilities issued by these chronically insolvent companies is estimated to be about W 10 trillion as of end-July 2001, which is only 2.7 percent of the banking system's asset and about 2 percent of the nation's GDP. [48] A sensitivity analysis reveals that even when the interest rates are increased in the course of future economic recovery, the adverse effect on the borrowing cost will not be especially large.[49]

This suggests that the government should not be too concerned about the systemic threat posed by a sudden foreclosure of the insolvent firms from the system.

IV. Conclusion

Rather the issue now is how to promote the orderly exit of these companies in a more liberalized environment. In this sense, the government's efforts to reform the framework of insolvency law should receive a highest priority. The central policy direction should be to address the inconsistencies among the three insolvency laws (i.e., Bankruptcy Act, Corporate Reorganization Act, and the Corporate Restructuring Act).

Also, in the mature stage of economic reforms, the financial and corporate restructurings need to be carried out by market forces rather than the government's initiatives. The government has recognized the importance of settling in place a *constant market-driven restructuring system*, which empowers the creditors and concerned investors in the markets to take on the role of monitoring, identifying and weeding out non-viable players. Under this new system, it is the strong market discipline not the government's interventionist policies that should lead the restructuring process.

Korea has already made some progress in this direction, such as the introduction of a more rigorous bank accounting standard (called the forward-looking criteria), the promotion of a hostile

48 See KDI (2001)

49 A recent IMF study found that a 100 basis point increase in the interest rates over a one-year period would have raised the number of companies with ICR of below one by only 6 and lowered slightly the average interest coverage ratio from 2.3 to 2.14.

M&A market, and more recently the enactment of the Corporate Restructuring Promotion Act. In particular, the new act contains many provisions regarding voluntary participation and coordination among creditor institutions in the corporate restructuring process.

Despite this progress, further steps are needed to create an environment where market discipline could play an important role in the constant restructuring system.

Among others, early privatization of the banks under government ownership should be a high policy priority. Also, in order to strengthen market discipline, we should continue to implement market-complementary measures: such as enhancing corporate governance and shareholder activism; bringing accounting practices more closely in line with international best practices; improving the scope for capital market to exercise influence on market participants; and making the market for corporate control (e.g. M&A market) more efficient.

Appendix 1. Korea's macroeconomic vulnerability

While macroeconomic vulnerability can be defined in many ways, we seek to focus here on the early warning signs of exchange market pressures by examining the following three leading indicators:

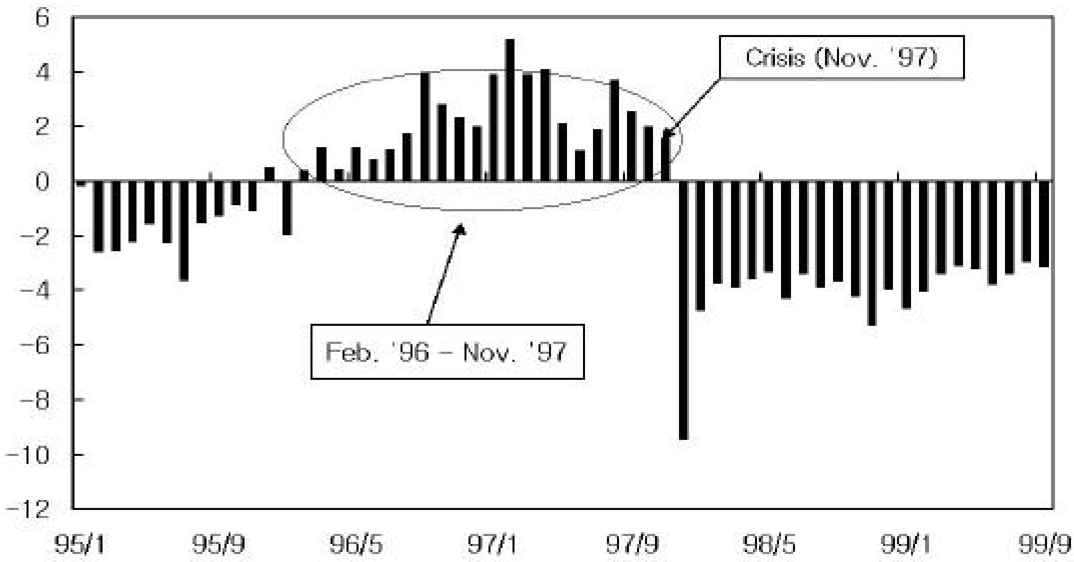
The first vulnerability index, which measures the deviation of the real effective exchange rate from its three-year moving averages, has risen well above the trend since mid-1995 and has stayed at excessively high levels, especially during February-July of 1996. With the estimated time lag of about four quarters, this overvalued exchange rate of the won caused the significant widening of the country's current account deficit in mid-1997.

The rise in the second vulnerability index, which measures the deviation of M2/reserve ratio from its three-year moving averages, became more pronounced over the twelve month period preceding the crisis. This implies that the growth of Korea's liquid banking liabilities became excessively high as compared to the stock of foreign exchange available to meet those liabilities. The index rose rapidly since August of 1997, as a result of a precipitous decline in international reserves.

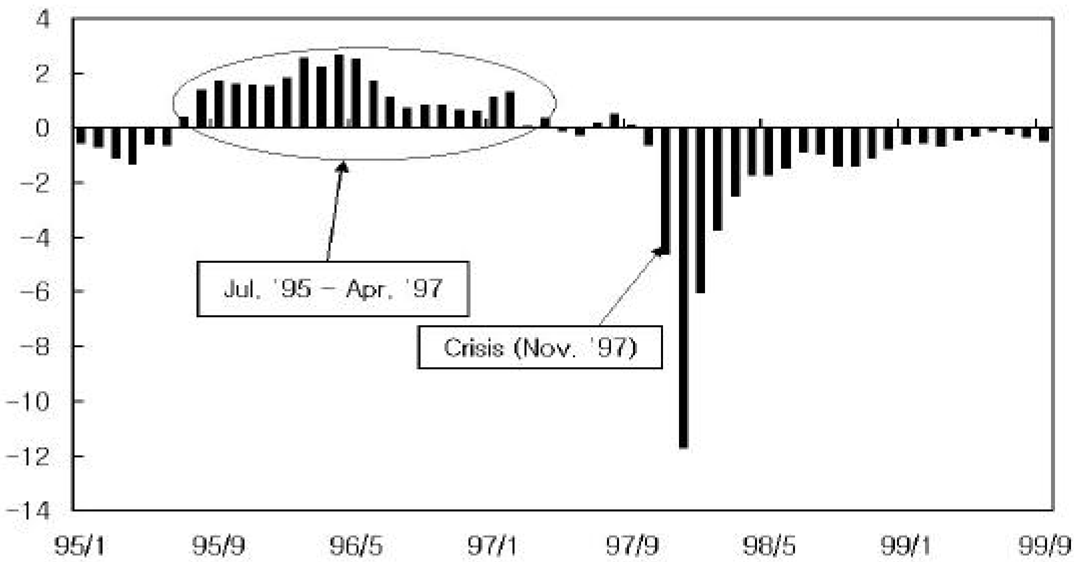
The third index, which measures the deviation of the domestic credit growth from its three-year averages, rose progressively since mid-1996 and stayed at high levels through the crisis.

The composite index, which is a weighted average of the three indices, provides a more reliable early warning signal for macroeconomic and financial vulnerability. As <Chart 6-1 6-4> shows, the composite index rose well above the trend and stayed in excessively high levels from February of 1996 to November of 1997. After the crisis, however, it fell to well below the trend, signaling an absence of the same type of risks that precipitated the Asian crisis.

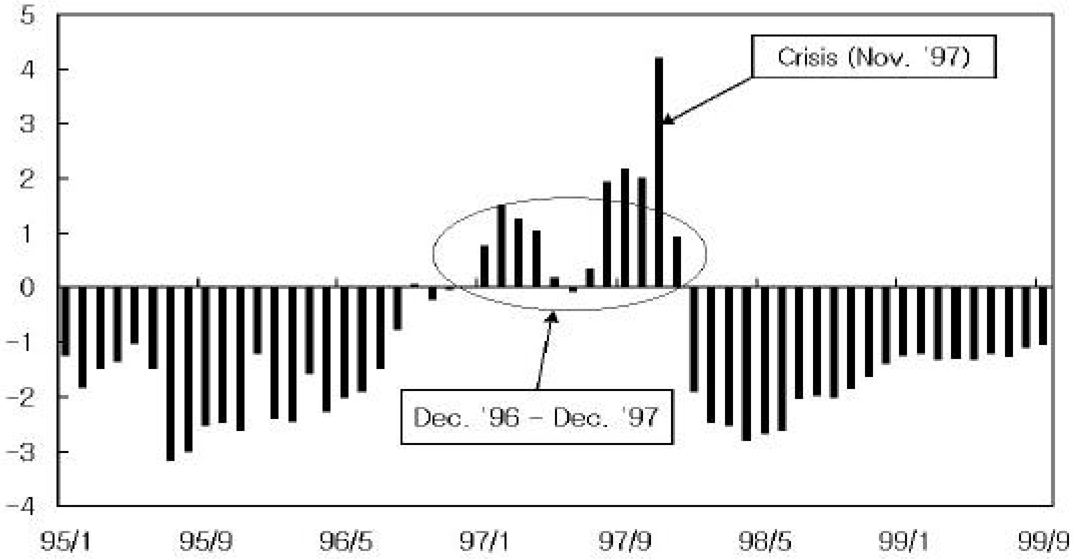
<Chart A-1>   Composite Vulnerability Index: Korea



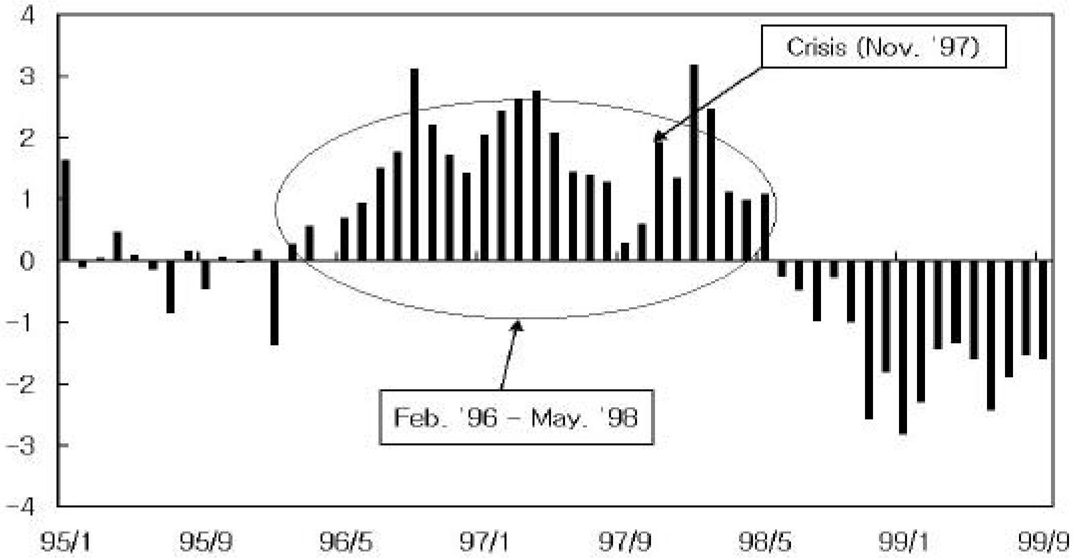
<Chart A-2> Vulnerability Index 1: Deviation of Real Effective Exchange Rates



<Chart A-3> Vulnerability Index 2: Deviation of M2/Reserve Ratio



<Chart A-4> Vulnerability Index 3: Deviation of Domestic Credit Growth



References

Yoon Je Cho, *Economic Adjustment Program of Korea After the Crisis: What have we learned ?*, Conference on the Korean Crisis and Recovery, Seoul, South Korea, May 2001.

Charles Enoch, Barbara Baldwin, Olivier Frecaut, and Arto Kovanen, *Indonesia: Anatomy of a Banking Crisis: Two Years of Living Dangerously*, IMF Working Paper, WP/01/52, May 2001.

IMF, *Financial Sector Crisis and Restructuring: Lessons from Asia*, Occasional Paper 188, 1999.

IMF, *Republic of Korea: Economic and Policy Development*, IMF Staff Country Report No.00/11, February 2000.

IMF, *Korea-2001Article IV Consultation Mission: Concluding Statement*, November 2001.

Jang-Yung Lee, *Monetary and Financial Policies in Korea After the Crisis*, International Forum on the Revitalization of the Asian Economy and Financial Markets, Tokyo, Japan, February 2000.

Ministry of Finance and Economy of the Republic of Korea, Public Fund Management Committee, *White Paper on Public Fund Management* (in Korean), August 2001.

OECD, *2000-2001 Annual Review--Korea*, June 2001.

Comment

Paul F. Gruenwald
Resident Representative
IMF Seoul

At the outset, I would like to thank the Ministry of Foreign Affairs and Trade, the Korea Institute for International Economic Policy and the OECD for inviting me to be a discussant at this distinguished conference.

The subject of structural adjustment and systemic risk is clearly an important one, and the participants of this conference have benefited from three complementary papers in this area: Ms. Atkinson has focused on financial sector issues; Dr. Michalski has focused on corporate sector issues; while Dr. Lee has given us key insights into the Government's strategy. All should be congratulated on the quality of their contributions. I agree with much of what has been written, and have only a few comments; my remarks will therefore be relatively brief.

In their own way, each of the papers has tried to define systemic risk. Clearly a systemic risk reflects more than simply a negative externality having an impact on a public good. Air pollution from industry would qualify under this definition but the policy response — the government creates a market by allocating to firms tradable rights to pollute — is not controversial and one would be hard-pressed to call this systemic, important as clean air may be to us all. What we are after is something more akin to the lifeblood of the economy, and Dr. Michalski's analogy to a large natural disaster is useful in characterizing the magnitude of the problem we are considering. In that sense, the focus in all three papers on the payments and settlement systems seems well placed. That said, the applicability of such a definition will almost always involve a difficult judgment, and Dr. Lee's paper contains a number of examples of the kind of processes the Korean government went through in assessing whether risks were systemic or not, and whether any systemic risks were large enough to justify government intervention. What seems clear to me is that if the costs associated with the realization of systemic risks as defined here are large and at least partly avoidable through policy measures, then a case for government intervention can be made.

Structural adjustment is always a protracted and difficult process, including both politically and socially. One tends to put the arguments for structural reform in terms of economic efficiency, but there are obvious social and political costs and risks that also need to be taken into account. While I do not see these types of risks as systemic — unless of course they threaten the very social fabric of the entire country — they should not be dismissed out of hand. As Dr. Michalski points out, there are winners and losers resulting from the structural reform process and, like the standard free trade argument, resources can be reallocated to cushion the impact of reform on those hit hardest. This deserves more than lip service; specifically, a well-functioning social safety net should be put in place under these circumstances, as the Korean government did in 1998. I also agree with all authors that structural reform needs to move ahead and that delaying reform usually increases costs down the road. But I wonder (and not only in the Korean context case), whether forbearance is ever good structural policy given the systemic risks, and if so when, and in what form?

On the economics, I agree in principle with Ms. Atkinson's concerns about moral hazard. Any government intervention in the types of situations we are discussing today needs to strike a balance between addressing the immediate systemic concerns, and encouraging future risky behavior by investors who may think that certain institutions may be too big to fail. The libertarian model—that of no intervention under any circumstances—suffers from a time inconsistency problem. I find it very difficult to believe that when faced with a credible systemic risk a government would choose to do nothing, whatever its previous commitment.

Considered as a whole, I detected some tension in the papers between interventions taken by policymakers as a crisis is receding as opposed to those taken in the depths of a crisis. Obviously, there are risks to the payments and settlement system in both cases. As noted in the papers, we would ideally want all government interventions to be market-friendly, transparent, etc. but the devil again appears to be in the details, in this case the timing. Government interventions undertaken in Korea since 1999 have been made in a very different environment from those taken during the depths of the crisis in late 1997 and 1998. For example, the extension of a blanket guarantee to all depositors and creditors of banks was arguably not a market friendly measure, but was needed given the huge loss of confidence and the risk to the payments system, and was generally considered to have been effective. How are the rules or conclusions regarding ideal or optimal government intervention—for example, relating to market friendliness—different after a crisis has passed and during the depths of a crisis? Are we being consistent in defining our ideal intervention across these two cases? Should we be consistent?

I would like to conclude by discussing briefly the policy response to the presence of systemic risk *itself*, as distinct from the formulation of structural policy with regard to systemic risk. In contrast to natural disasters, which emanate from purely exogenous factors, systemic risks relating to the payments and settlement systems can be mitigated by appropriate policies, some of which are themselves structural.[50] I will focus on prevention, which, while perhaps obvious, bears repeating. Since the financial system is at the epicenter of most crisis and is intertwined with the payments and settlements system, the preventive agenda should include strong supervision of both banks and non-banks, adherence to international accounting and disclosure standards, adequate capitalization and good risk management practices. Due attention should be paid to corporate performance as well, as weaknesses in the corporate sector often have a direct impact on bank balance sheets and hence affect systemic risk. In this vein, good governance in all forms should be facilitated—including, again, adequate standards for accounting and disclosure, the presence of outside directors on corporate boards, a well functioning insolvency system, shareholder rights—as well appropriate risk management. While arguably not very sexy, prevention remains a key element of the policymaker's toolkit, particularly in economies like Korea undergoing structural reform.

50 However, as Dr. Michalski rightly points out, the costs of natural disasters do contain an endogenous element, for example from policies encouraging building in earthquake zones.

Comment

Yunjong Wang
Director, Department of International Macroeconomics and Finance
Korea Institute for International Economic Policy

East Asia is feeling the heart of a world in recession. Many countries in this region have experienced increasing disappointment in most export businesses. In the tough external climate of a synchronous global recession, the appetite for government-led economic reform has dramatically receded in every corner of the region, while market-led restructuring is taking place. The call to save the world economy from severe deflationary pressures has become a catchphrase. However, we are well aware of the conventional wisdom that delayed reform will lead to more serious repercussions at the start of the recovery phase. My simple question is whether economic reform and restructuring is really incompatible with a macroeconomic stabilization policy. My observation is that policy makers are tempted to justify delayed reform.

First, policy makers are inclined to use the notion of "systemic risks" by asserting that structural adjustments are necessary and beneficial in the long run, but the short-run adjustment costs are unbearable. In this context, a mild and gradual approach tends to be more acceptable to policy makers than shock therapy or a big-bang approach. Certainly it is true that economic restructuring cannot be achieved overnight. Furthermore, costs of adjustment will be magnified in the absence of supporting institutions and a social safety net to facilitate the adjustment process and mitigate political pressures. Thus, systemic risks should be managed in order not to disrupt the whole economy. But, this line of justification has some pitfalls.

Let me take the case of Japan. Japan has experienced a lost decade since its bubble economy burst in early 1990s. The world's second largest economy underwent a banking crisis ten years ago. In the early 1990s, Japanese policy makers justified forbearance by asserting that land priceswould pick up soon. This false belief and complacency caused a banking crisis in late 1997 in the midst of the Asian financial crisis. The day before yesterday, at an international symposium hosted by the Korea Deposit Insurance Corporation, Professor Takatoshi Ito of Hitostubashi University, highlighted the current gridlock among policy makers in Japan.

The Bank of Japan does not want to ease its monetary policy unless fiscal discipline is restored, progress in structural reform is made, and banks restore healthy balance sheet. According to him, the Bank of Japan argued that in the absence of such conditions, monetary easing encourages moral hazard.

The Ministry of Finance resists using more active fiscal stimuli by asserting that deficit spending will raise fear of default and may prompt a rise in the interest rate.

The Financial Services Agency (FSA) is not being tough on banks to clean up their NPLs (non-performing loans) because they fear it may lead to lots of corporate bankruptcies. Now that the NPL problem caused by the bubble is over, there is a new NPL problem due to deflation. So, the FSA justifies its inaction by saying that unless the Bank of Japan finds a way to stop deflation, a new NPL problem will emerge.

Also, the political circle and cabinet office argue that structural reforms cannot be carried out unless safety net is well prepared.

As Dr. Wolfgang Michalski has pointed out , the notion of systemic risks is not a well-defined concept. It is a generic term, so it is vaguely used when the costs of adjustment are not precisely measured, but unexpectedly huge in some bad contingencies. In particular, financial markets are incomplete and imperfect. So financial panic may be created by even genuine intentions to achieve financial restructuring. However, one of the most topical issues these days is how to maximize the benefits of structural reform while minimizing the systemic risks. Sometimes answers can be easily found, but policy makers are tempted to take a politically palatable choice. In the case of Japan, depreciation of the yen would be least costly option for policy makers. They do not want to touch on politically sensitive issues such as pension reform and labor market adjustment. The least costly method of adjustment can often be found the most politically difficult method.

Regarding banking reforms, there are many good recommendations proposed by world-class specialists and international organizations. For instance, the introduction of transparent rules and better loan classification systems should be welcomed. However, in practice, the key question is the mix of discretion and rules. Because no simple rule can be fair, there exists plenty of room for discretion. Furthermore, strict enforcement of rules is another matter. Although everybody agrees that better enforcement is needed, improvement of enforcement will be costly.

Given the gridlock among policy-making circles in Japan, one cynical stance states that the problems can only be overcome by crisis. As was the case in Korea, crisis can be a mixed blessing. A stop-gap policy executed in fear of systemic risks will snowball the systemic problems. Today's painful adjustment will be less painful in the long run. So, the notion of systemic risks should be accepted, but carefully handled.

Another pitfall of policy makers' inaction and their justification is the mythical explanation of lack of supporting institutions. Building legal frameworks and institutions can be a relatively easy project. An important issue will be how to operate the institutions supporting the structural adjustment. If policy makers are really enthusiastic about structural reform, legal and institutional setting is not a big headache. The reason why most restructuring fails to go beyond the superficial and cosmetic is basically due to bureaucracy. There are plenty reasons for government intervention. In particular, institution building is a job of the government. But the operation should follow along with the markets and market discipline. Systemic risks should be also managed by well functioning markets. For instance, closure of failed banks may lead to a short-run credit crunch, but a bailout policy violates market discipline, and further undermines the system. If bank runs are to be avoided, we should first understand why bank runs take place. Bank runs can be created by sun spots or self-fulfilling expectations. But in most cases, unsound banks have a higher probability of being attacked. Unless systemic risks are considered in light of market discipline, government interventions will magnify latent problems and may lead a failure or total collapse of the system.

Comment

Chungsoo Kim
Deputy Director, Joongang Economic Research Institue
The Joongang Ilbo

As an observer of what has happened over the last four years, I note the following phenomena of restructuring and economic reforms.

As compared with pre-economic crisis, the current situation differs in many respects. The numbers of financially troubled companies and financial institutions and and their numbers of owners, managers and workers have been reduced. The legal institutions concerning corporate governance and prudential regulations have been improved and strengthened. And the biggest change is that the bad loans of private sector have turned into public debts.

But many note that the realms of businesses, of corporations and financial institutions, more or less remain the same as before. Many doubt whether the capacities of financial institutions in terms of prudent risk management and sound credit disbursements have been strengthened. And equally many consider the restructuring and the improvement of profitability of private companies not sufficient

Too excessive concern of the government about systemic risks and too generous infusion of public funds thereof, in combination with not so stringent prerequisites of restructuring attached to them, have all much to do with such status of financial institutions.

The moral hazard on the part of financial institutions as created by such loose financial supervisory measures has much to do with not so satisfactory results of corporate restructuring.

I think the core shortcoming of the institutions and policies, that tend to slow down the process of restructuring, thereby eventually increasing cost of restructuring and raising the stake of systemic risks, resides with their oparkness.

The first exemplery case is the prompt corrective measures. Admittedly, as compared with the pre-crisis ones, the statutory mandates of the financial supervisory authority, that has to implement prompt corrective measures onto those financial institutions with un-sound capital adequacy, have been made more stringent. But the linkages between capital inadequacy and prompt corrective measures are fuzzy in terms of contents and extent.

Thus, the financial institutions would not know how exactly bad their capital adequacy could be before prompt corrective measures would be triggered. Once they are triggered, the financial institutions would not know what kind of bad loans would be purchased by KAMCO, let alone, how extensively they have to carry out restructuring to invite infusion of public funds.

The immediate result is that the financial institutions, rather than spend their time and energy to quickly recoup the capital adequacy, concentrate on getting lenient prompt corrective measures from the government.

The other example of opark restructuring institution is related with troubled big companies. When we embarked on serious reforms of Chaebols, the key word was “no more too-big-to-fail.” The experience of last few years says, however, “too-big-to-fail” remains strong as ever. To be more correct, I would say, it has got markedly stronger ever since the government officially declared Korea has overcome the economic crisis. The pround government is at such a position to let a big company go bankrupt and lose face.

So, the most serious problem here is that although the government repeatedly denies the intention and actual deeds of intervention, even the major creditors would be busy to find what the plans of government are concerning the fates of troubled companies. This explains the volitility of market whenever the news of new troubled companies breaks out, and it has a lot to do with the slow pace of their restructuring.

Maybe this results from the irresponsibility of creditors, but the market, which has observed how what-so-called Big Deals have come about and what has happened with major bankrupcy cases says, otherwise. It says the government still looms behind the decisions of creditor institutions on major bankrupcy cases.

So, I suggest two things. First, true to its saying and in spite of concerns of systemic risks, the government should take “hands-off” stance with respect to even cases of big troubled companies and let the market have a chance to work them out. Second, the room of discretion by the financial supervisory authority should be minimized. This can be done by making the statutory mandate of prompt corrective measures as stringent as possible and make the linkage between the promt corrective measures and the capital adequacy of financial institution as transparent and detailed as possible. This will contribute to turning restructuring of financial institution as continuous work, and as a result, minimizing the systemic risks.

On this rare occasion of taking stocks of systemic risks, I would like to make an observation on the financial condition of the public treasure. There are growing number of observers who have serious concern about the deteriorating status of fiscal deficit of Korea.

More specifically, they note that the macro-economic condition is expected to remain weak within the next few years, and that the repayment obligations on massive public debts are scheduled to mount quickly during the same period of time.

Thus, many have doubts on whether the Korean government could meet the debt service schedule as it stands now or whether it could successfully reschedule it. Some go as far as to describe the situation that there is an imminent potential of fiscal crisis, the aftermath of which may generate a systemic risk of unimaginable magnitude. And all of them urge the government to embark on diffusing it as soon as possible.

Comment

Moon-Soo Kang
Senior Research Fellow
Korea Development Institute

The credit crunch problem after the financial crisis in 1997 could not be resolved without first promptly addressing the issue of insolvency among the financial institutions themselves. Any delays in financial sector restructuring would undermine the soundness of the whole financial system which, in turn, could lead to serious repercussions for Korea' s fundamental economic base.

Depending on the nature of the crisis, authorities can apply a number of selected support measures. In the case of the financial crisis in Korea, which was characterized by widespread insolvency problems, a more active role of the government has been necessary.

The government has provided fiscal support to help financial restructuring. As of September 2001, public funds in the amount of 148 trillion won (including recycled amounts) were mobilized and used. As of June 2001, 590 financial institutions, including 11 banks – accounting for 29 percent of the financial industry – were either closed or merged, while the number of bank employees has fallen by 38 percent.

Thanks to appropriate policy responses that rectified those factors leading to the economic crisis, Korea has made remarkable progress in many critical areas. The speedy containment of systemic risk and the domestic credit crunch problem through an injection of large public funds for bank re-capitalization was a critical step toward normalizing the financial system and market.

However, financial institutions are still burdened with heavy non-performing loans. Non-performing loans at banks totaled 27.4 trillion won (5.04 percent of total loans) at the end of September 2001. The non-performing loan ratio of all financial institutions was 7.3 percent at the end of September 2001. Continued corporate restructuring and the implementation of the forward-looking criterion (FLC) of loan classification standards caused the amount of substandard loans to increase even more.

KAMCO has purchased a total of 99.5 trillion won (face value of US$79.6) in non-performing loans from financial institutions and resolved 53 percent of the purchased total by August 2001. However, KAMCO' S role as the government agency responsible for resolving non-performing loans is scheduled to end in November 2002.

As of June 2001, KDIC injected 78.3 trillion won (US$62.6 billion) in re-capitalization funds for financial institutions and payouts to depositors in the process of closing non-viable financial institutions.

The prudential supervision standards themselves were strengthened to fully meet the Basle Committee's 25 core principles of banking supervision. The National Assembly enacted the Financial Industry Structure Improvement Act (FISIA) in 1997, and stipulated prompt corrective action provisions in the FISIA. Prompt corrective action reduces the likelihood of failing financial institutions' engaging in risky and potentially expensive attempts at redemption when permitted to stay in business. Regulatory authorities should secure a reputation of tough supervision by acting promptly and stringently in the face of financial problems, which would in turn have a positive influence on financial market expectations.

The banking system should be restored to a functioning level. Banks operating on market principles are vital to a modern market economy. The privatization of commercial banks and the development of a market-oriented financial system should be a priority. Increased transparency and revealing financial statements that conform to international norms would facilitate distinguishing between banks with a future and those without a reasonable shot at profitability. Furthermore, consolidation of the banking and non-banking financial sector should be encouraged. Weak banks and financial institutions should be eliminated so that the prospects of recovery for stronger financial institutions could be improved. Non-performing loans must be recognized and removed from the balance sheets, and underlying assets sold. Policymakers and financial regulators should be aggressive in forcing banks to recognize losses and in disposing of underlying assets.

There is also need for reform in the capital markets. Now that numerous firms are faced with a compelling need to expand their equity base, the equity market will have to take on a more active role in corporate finance and monitoring.

The vulnerability of the Korean economy to external shocks should be reduced. In particular, corporate debts should be further reduced to a level comparable to that of advanced countries.

SESSION III

Sustainable Growth and the Role of Human Capital

The role of Human capital in long-term economic growth

Barry McGaw
Deputy Director for Education
OECD

Introduction

It is both an honour and a pleasure for me participate in this conference to celebrate the fifth anniversary of Korea' s joining the OECD. From the point of view of human capital development, the focus of this session, Korea is a very interesting country because of the evident commitment of its people and governments to education.

Korea' s economic development over the last four decades has been remarkable. In the early 1960s, Korea' s per capita income was lower than that of any Latin American country and only marginally higher than Afghanistan' s (Maddison, 2001). Today, as Figure 1 shows, Korea' s per capita income is above those of seven of the other 29 OECD countries and close to those of Portugal, Spain and New Zealand.

While Korea ranks 23rd in wealth, as measured by GDP per capita, it ranks second in its commitment of national wealth to education. Korea allocates just over 7 per cent of its GDP to expenditure on educational institutions - 4 per cent comes from public sources and 3 per cent from private sources. In the allocation from public sources, Korea ranks 25th among OECD countries. It is the substantial private investment that raises it to 2nd rank (OECD, 2001a).

Undoubtedly many factors have contributed to Korea' s spectacular economic growth over the last four decades, but it is clear that more and better education has been a crucial one. Human capital is widely recognised in contemporary discussions as a important contributor to economic growth. Until recently, the debate had focused on physical capital and new technology - in particular information and communications technology. There is now, however, increasing recognition that, in the absence of the adequate human competencies, the growth effects of physical investments are likely to be small. The recent OECD (2001c) publication, *The New Economy: Beyond the Hype* acknowledged that human capital is absolutely essential to the success of the long-term growth strategy[51]. This seems to be well understood in Korea. While Korea ranks 23rd among the 30 OECD countries in GDP per capita, it ranks second in terms of

51. "growth is not the result of a single policy..., but [of] a comprehensive and co-ordinated set of actions... . This depends more than ever on improving the quality of human capital and responding to the changing demands of the workplace and society more broadly." (OECD, 2001c, p.97)

The key questions for future policy development are in just what ways does education contribute to contemporary economies and what education policies might secure and enhance those contributions.

Human capital as a productive factor

Recent empirical research confirms the significant impact of investment in human capital on economic growth. Work at the OECD by the Economics Department and the Directorate for Education, Employment, Labour and Social Affairs estimated that an increase of one year in the average educational attainment of a country would raise per capita GDP by between 4 and 7 per cent. Analyses of the changes in economic performance in OECD countries between the 1980s and the 1990s show human capital investment to be one of the most powerful engines of economic growth. Interestingly, on average, its impact has been larger than that of physical investment.

There are three key growth-enhancing effects of human capital. First, it contributes to economic efficiency. Secondly, it provides the labour resources on which growth depends. Thirdly, it can reduce social inequalities and, potentially, make growth more sustainable.

Contributing to economic efficiency

The contribution of education to economic efficiency lies in the very nature of the current growth process, that is that new technology and skilled labour complement each other:

Information and communications technology has emerged as a key technology with the potential to transform economic and social activity, but success lies in the use of the technology, not in its production, and human capital is essential to its effective use. It is too early to say how important the transformations generated by this new technology will be, compared with those of previous major innovations like electricity, but one thing is clear. There is a strong complementarity between the new technologies and skilled labour (Arnal et al., 2001). In order to realise the full growth potential of the new technology, it is essential that our human capital investments are put into place the right human competencies to achieve this complementarity.

More generally, economies are increasingly based on knowledge, and less on physical capital or natural resources, and knowledge is characterised by strong network effects. Knowledge spillovers have been magnified with the rapid diffusion of new technology. The result is that the potential benefits of innovation and new knowledge have increased considerably. In other words, the more people have access to knowledge, the greater are the likely economic benefits of knowledge. This is why it is more important than ever to ensure that no groups in our societies are left isolated by their inability to access education opportunities.

These spillover effects are at the centre of the "new growth" theories developed by economists such as Robert Lucas (1988) and Paul Romer (1990). According to these theories, new designs and ideas created by research and development and knowledge-intensive sectors enhance the productivity of physical capital investment in other sectors and regions. For example, a growing, "leading-edge" export sector can leverage knowledge and innovation throughout the whole economy through mobility of skills and entrepreneurs and through dissemination of new technologies and products.

Providing labour resources for growth

The second growth-enhancing effect of human capital lies in its provision of the labour resources on which growth depends. Better human capital is typically associated with higher employment and that, in turn, provides the labour resources needed to support growth.

This is especially important in view of the major demographic challenge of population ageing that most OECD countries, including Korea, will be facing. Reflecting falling natality rates, the number of people of working age is growing slowly, and it may even fall in some countries after 2005-2010. At the same time, people are living longer but also tending to retire earlier. Much has been said about the socio-economic risks entailed in these conflicting trends - notably regarding the viability of pension systems and indeed the sustainability of the growth process - but it is clear that adopting a lifelong learning perspective is central to meeting the ageing challenges.

Promoting learning throughout the working life reduces the danger of skill obsolescence at older ages, thus supporting the employability of older workers. More fundamentally, education improves the employment prospects of the entire workforce: the higher the level of educational attainment, the higher the labour market participation rates. Chart 2 provides an interesting illustration, showing the employment patterns of Koreans of working age by level of education. Three quarters of those with tertiary education are employed, compared with slightly more than half of those with less than upper secondary education.

Chart 2, of course, shows only the relative advantage in the labour market conferred by additional education. It does not necessarily mean that, if those with lower levels of education had more, they would achieve the higher employment rates currently enjoyed by their better-educated peers. That would occur only to the extent that the availability of a more highly qualified labour force supported the development of growth-enhancing activities. The fact that improved education is associated with higher quality jobs, typical of knowledge economies, offers some encouragement for this expectation.

There is evidence that the Korean the structure of the Korean labour market may not support investments in lifelong learning. A recent OECD (2000) study, *Pushing ahead with reform in Korea: A review of labour market and social safety-net policies*, shows that the incidence of atypical and low-quality jobs is high in Korea. Indeed, Korea has one of the most "dual" labour markets in the OECD area. In 1999, more than half of all employees had either a temporary or a daily contract, the remaining having a "regular" (*i.e.,* open-ended) contract. In international comparisons, Korea has the highest share of non-regular jobs in total employment. Many workers feel insecure about their jobs, which is problematic in and of itself. In addition, employers tend to be reluctant to train workers on temporary or daily jobs. As the Figure 3 shows, better-educated workers are less likely to be in non-regular jobs than their less well educated counterparts. The problem may become smaller as new, better-educated cohorts enter the labour market though, as a study by Martin and Torres (2000) shows, action in the area of labour markets and social safety nets are also needed.

Making growth sustainable

The first growth-enhancing effect of human capital was its contribution to economic efficiency and the second its provision of the labour resources on which growth depends. We come now to the third, which is based on the political economy argument that better human capital can help reduce social inequalities, making the growth process more sustainable.

Though they often disagree among themselves, economists have consistently advocated a range of policies designed to speed up economic growth and raise living standards. Other speakers at this conference have already pointed to freer and more open markets, higher investment in new technology and more efficient resource allocation as sensible economic policies but, unless society accepts them, governments will be reluctant to implement them. Here is where human capital also comes into the picture again. Higher, common levels of education can reduce social inequalities and improve social cohesion, thus making the growth strategy socially acceptable.

Economic history demonstrates that freer trade will improve living standards for a nation as a whole. Even so, trade liberalisation may be resisted by groups that fear for their jobs and incomes. This is so especially when trade liberalisation provokes structural change, thereby requiring a degree of labour mobility. But when workers are equipped with the right skills, they will be in a better position to cope with, and accept, structural change.

In addition, a more equal access to education has the potential to reduce income inequalities, which may help improve the social sustainability of growth policies. Indeed, some argue that inequalities in income distribution may cause social and political unrest, which would discourage investment and slow growth. According to a recent OECD study, "this line of argument has been used particularly in the case of Latin America to draw a link between inequality and radical shifts in government policy and even in the form of government. The consequences may include support for confiscatory policies, including uncompensated land reform, excessive regulation, and even a tolerance of petty corruption" (Arjona *et al*, 2001).

Building human capital in Korea

So much for the role of human capital in economic growth. I turn now to the issue of building human capital and, in particular, to the education and training system in Korea. The key question is how well is it adapted to these changing economic requirements.

Building a sound basis in compulsory education

The compulsory school system plays a critical role in human capital formation. Schools do this both directly, by building individuals' substantive competencies through the range of subjects offered, and indirectly, in building individuals' capacity and motivation for future learning.

The OECD has recently introduced a new dimension to its work on education indicators to provide some direct measures of the yield of the compulsory education system. The OECD Programme for International Student Assessment (PISA) will survey students' performance levels in reading, mathematics and science every three years in all OECD countries, and in a growing number of other countries as well. The first survey was conducted in 2000, with assessments of more than 260 000 15-year-olds at school in 32 countries, and the results were published last week (OECD, 2001b). Most attention was given to reading in PISA 2000. Mathematics will be the major domain in PISA 2003, science in PISA 2006 and then reading again in PISA 2009.

The PISA assessments are not concerned primarily with knowledge acquisition. The focus is on what students can do with what they have learned. To reflect this orientation, the main domains of assessment are referred to as 'reading literacy', 'mathematical literacy' and 'scientific literacy'. Information was also obtained from students on the techniques they use to manage and monitor their own learning and on their motivation towards learning in general and the subject domains assessed. Background information on the students and the schools was obtained through questionnaires completed by the students and the principals of their schools.

Since reading was the major domain in PISA 2000, it was possible to develop assessments for three separate scales – one for retrieving information in text, a second for interpreting text and a third for reflecting on text in relation to one's own knowledge and evaluating and arguing about the issues raised in text. While these three scales differ in complexity – with complexity increasing from retrieval to reflection and evaluation – tasks over the full range from simple to difficult for 15-year-olds were developed for each scale. Overall performances are also summarised on a combined reading literacy scale.

On each of the reading literacy scales, five levels of performance were distinguished. They provide a means by which the distribution of performances, as well as the average performance, within countries can be described. In fact the distribution is more interesting than the average for the analysis of between country differences.

In average performance on the combined reading literacy scale, Korea ranks between 4th and 9th[52]. The three countries with mean scores significantly ahead of Korea are Finland, Canada and New Zealand. The five countries with mean performance levels not significantly different from Korea are Australia, Ireland, the United Kingdom, Japan and Sweden. Korea's position, relative to other countries is marginally higher on the retrieving information scale than on the interpreting texts and on the reflection and evaluation scale.

National mean scores, however, tell only a very limited part of the story. The differences in spread of scores over the five levels on the combined literacy scale, shown in Figure 4 for eleven of the OECD countries[53], tell a more complex and interesting story.

Finland achieves a high mean, with almost 20 per cent of its 15-year-olds at Level 5 and less than 7 per cent at Level 1 or below. Korea stands out as a country with a high mean but with relatively few students at the highest level. Even the United States, which ranks between 10th and 20th in mean score, has a considerably larger percentage at Level 5 than Korea (12 per cent compared with 6 per cent). What keeps the Korean mean high is that there is less than 6 per cent at Level 1 or below – the smallest percentage of low achievers in any country. By contrast, what drags the mean for the United States down is the 18 per cent of students at Level 1 or below.

Korea's results in reading literacy show a remarkable degree of equality that has been achieved without sacrificing quality. Indeed, Korea, Finland and Japan all provide clear evidence that it is possible to achieve both quality and equality in educational outcomes. For Korea itself, however, there could well be some dissatisfaction with the relatively low numbers of students performing at the highest level. If these numbers could be increased, the mean would rise further . Even if the lower performing students were not raised much, there would still be a degree of equality in outcomes greater than in virtually all other countries. Raising the performance levels of the best-performing students may not be easy but it will be easier than the task of raising the performance levels of the poorest-performing students which, as Figure 4 makes clear, is the challenge for Germany, Italy, the United States and France.

In mathematical literacy and scientific literacy, Korea performs even better than in reading literacy. In mathematical literacy, Korea ranks 2nd or 3rd, behind only Japan and ahead of all others but New Zealand. In scientific literacy, Korea ranks 1st or 2nd, essentially tying with Japan at the head of the list. Again, the high means are achieved with substantially more equality among students than in most other countries.

52. Korea's rank on means was 6th but other countries were sufficiently close for there to be no significant difference, taking account of measurement error, between Korea and those ranked from 4th to 9th.

53. The information for all participating countries is provided in Figure 2.3 in the full report (OECD, 2001a, p.45).

Not only does Korea achieve a high level of equality in the performance levels of all its 15-year-olds, it also manages to ameliorate the impact of social background on performance. Figure 5 shows the relationship between students' performances on the combined reading literacy scale and a measure of their socio-economic background (using an index based on parental education, occupation and wealth plus cultural possessions in the home).

The dispersion of the points (each dot in the figure representing 20 000 students) around the regression line for the OECD as a whole makes it clear that socio-economic background is, of course, not the sole cause of variation in reading literacy. Some students from privileged backgrounds do not perform well and, conversely, some from low levels of privilege do perform very well. From the extent of the dispersion about the line it can be determined that, for the OECD as a whole, differences in socio-economic background account for 20 per cent of the variation in student performances.

Examination of the separate plots for each country shows that the link is much weaker in Korea and Finland, where differences in socio-economic background account for only 9 per cent of the variation in reading literacy, and weaker still in Japan where it is 6 per cent and Iceland where it is 5 per cent. In Germany social background accounts for 22 per cent of the variation in reading literacy.

The slope of the line also tells a story. It indicates how much difference in level of performance is associated with differences in socio-economic background. The index of socio-economic background is expressed in standard deviation units, so around two-thirds of the students lie between scores of –1.0 and +1.0 on this scale. From the line for the OECD as a whole, it can be seen that the difference in the average reading literacy of students one standard deviation below the mean on socio-economic background and those one standard deviation above is around 80 score points – from around 460 to 540. That is more than one proficiency level on a scale with just five levels. Korea and Japan have the lines with the gentlest slopes for all the OECD countries. In both countries the difference in average reading literacy for those at the top and bottom of the middle two-thirds of students in socio-economic status is only around 40 points. Finland also has a line with a gentle slope. In these countries, variations in socio-economic status do not make much difference. Germany stands out at the other end of the spectrum. It has the steepest line indicating that differences in socio-economic background are associated with more difference in educational performance than in any other country. The gap in average reading literacy in Germany is around 120 points – more than two proficiency levels – between those one standard deviation below and those one standard deviation above the mean on socio-economic status. In the United Kingdom and the United States, differences in socio-economic background are also associated with marked differences in educational performance. In some countries social class seems to have much more influence on educational achievement than in others.

Finland, Korea and Japan stand out as countries that show, not only that quality and equality can be achieved together, but also that social privilege need not necessarily be translated into educational advantage. Disadvantage need not beget disadvantage. Other countries will want to know how the education systems and schools in Finland, Korea and Japan do it.

So is it all good news for Korea? Most of it is but there are some issues of concern.

There is point already made about the relatively low proportion of students performing at the highest level in reading literacy. There are also gender differences in Korea that are different from those in other countries. Females significantly outperform males in reading literacy in all OECD countries, males significantly outperform females in about half the countries and, in science, there are mostly no significant gender differences. In Korea, the advantage for females in reading literacy, while significant, is the lowest in the OECD, the advantage for males in mathematical literacy is equal highest in the OECD and, in scientific literacy, Korea is one of only three countries in which males perform significantly better than females and it is the one in which the difference is greatest. So, females in Korea do not perform as well, relative to males, as they do in other OECD countries.

Of course, PISA also provides a measure only at 15 years-of-age. There is much formal education to come, particularly in a country like Korea where participation rates remain so high right through university-level education. Competition for places in preferred university courses and the high-stakes examinations on which selection is based, impose considerable constraints on students. It can narrow learning to the content and style that is seen to be rewarded in the examinations and it can impose enormous time demands on young people in their final years of schooling, not only at school but also in additional coaching outside school. Those, I know, are issues of concern in Korea. They are in Japan also, where the current reform is attempting to reduce the scope of the curriculum to provide more time for students to engage in analytical work as opposed to knowledge acquisition.

It should be emphasised, however, that the PISA assessments on which Korean 15-year-olds have performed so well do not assess recall of information presented in a specific curriculum but rather on students' capacity to use what they have learned in real-life situations.

PISA 2000 gives us only a snapshot of current national performances, though we can add the pictures provided by earlier international surveys of student achievement in which quite a few OECD countries have participated. With its ongoing three-yearly cycle of assessments, PISA will build a good picture of trends across countries. And it will not simply show any shifts in country rankings. Results will be mapped onto the same performance scales so real movement, and not just relative movement, will be made clear.

Expanding post-compulsory education

We have no PISA-style information on performance levels achieved in post-compulsory education. All we have are completion rates but, from them, we can gain a picture of trends as well.

Trends can be explored by comparing the qualifications of an older cohort – say those aged 55-64 whose qualifications reflect the educational experience of young people a generation ago – with the qualifications of today's young people – say those aged 25-34. Figure 6 gives this information for Korea, the US, Japan and the OECD average.

When similar data for the 30-year gap are examined for all countries, we see two things: first a large increase over time in the proportion of people with both upper secondary and tertiary qualifications and, secondly, a dramatic improvement in the position of women, with women having caught up with the qualification levels of men in most countries, and surpassed them in some.

In Korea, both trends are not only visible, they are dramatic. Women have increased their participation in upper secondary education seven-fold and in tertiary education thirteen-fold. In key competitors, such as Japan and the United States, we see the same trends, but much less dramatic.

Challenges in strengthening the links and the benefits

While the performance levels of 15-year-olds and the high levels of participation in post-compulsory education in Korea are clearly success stories, there are challenges to be met in further strengthening human capital development and its links with economic development.

In identifying some of these challenges, I will draw on differences between Korea and other OECD countries. That leads to an entirely normative argument, of course, since it tends to result in the common practices of others being commended as though they are 'right' simply because they are common. Culture and history must also be taken into account but I have to leave it to you to do that for Korea. This is, after all, only my first visit to your country.

The first issue is the position of women in the labour market. Although the qualifications of young Korean women equal those of men, the proportion of women who work is lower than in many European countries and the United States – although about the same as in Japan. Figure 7 provides labour force participation for women by education level in Korea and the G7 countries.

The striking feature in Korea is that, unlike Western countries but to some extent like Japan, better education does not increase a woman's chance of participating in the labour force. Of course for women as indeed for men, the choice to work is a choice, and such choices are partly determined by cultural factors. It may be worth looking, however, at whether there are any particular barriers to the employment of women that could be removed for collective advantage.

A second issue is the economic returns from further investment in post-compulsory education. These returns for men could be more limited than in some other OECD countries, as Figure 8 shows.

A Korean male tertiary graduate earns less than half as much again as someone with no upper secondary education. At the other extreme, in the United States, male graduates earn nearly three times as much as their counterparts with only lower secondary qualifications. More generally, in Japan and other OECD countries, better-educated men can expect much higher earnings as a result of better qualifications than can their counterparts in Korea. These limited returns to education in Korea are almost certainly linked to the general reduction in wage differentials that has been observed in the Korean labour market over the past 20 years. Similarly, while in most OECD countries the risk of unemployment diminishes sharply with educational attainment, this is not the case for Korea.

There are also broader issues facing all OECD countries that Korea must also face.

First, countries need to find ways of making their educational resources go further, in order to expand opportunities for all to participate fully and appropriately in opportunities to learn throughout life. On the evidence of expenditure on schooling, Korea's investment is efficiently used. As Figure 9 shows, Korea achieves average results in PISA – on a combined result from reading literacy, mathematical literacy and scientific literacy – that exceeds what would be expected on the basis of its cumulative expenditure per student by the time the students are 15 years-of-age.

Second countries will need to find additional resources to expand learning opportunities further. In 1996, OECD Ministers for Education agreed on the common goal of lifelong learning for all, in recognition of the importance and range of contexts in which learning continues beyond the initial stages of formal education. They were also concerned – in the face of widespread evidence of inequality in educational outcomes and opportunities – that all people should be able to benefit from this lifetime process. This has been an immensely important initiative. Lifelong learning, although far from universal, is already very pervasive. For example, in Australia, nearly 40 per cent of the adult population take part in adult education or training each year, devoting an average of 264 hours to the activity.

Though there is broad agreement with the policy aim of lifelong learning for all, the thorny issue of who pays for it remains largely unresolved. It is essential to address this question, otherwise some of the policies advocated here may become pure rhetoric. A strong case can be made for encouraging a greater private contribution from individuals and enterprises in post-initial education. One way of doing this is to increase incentives to invest, for example, by making education outcomes more visible in the hope of creating more predictable returns. Qualifications frameworks are being developed in some countries to provide a clearer, more systematic basis for recognising skills acquired through both formal and informal learning. Another is to create mechanisms that make it easier to finance private investment, and various mechanisms are being experimented with. We in the OECD secretariat are actively engaged in both of these developments.

Also, across the OECD, the very economic success achieved in part due to improved human capital has made teacher recruitment more difficult. (This is true at university level as well as school level in many countries.) It is partly a matter of salary but also a matter of status, and not unrelated to the relative decline in the status of the public sector. Many OECD countries also have an ageing teaching force, with imminent high retirement rates that will exacerbate the recruitment problems. The job of teaching is also becoming more difficult with social changes such as increased alienation of some young people and even violence in the classroom. Teachers are an important key to success in our education systems. With this in mind, OECD Education Ministers recently asked us to launch a new programme of work to investigate both the quantitative issues of teacher demand and likely supply, and qualitative issues related to recruitment and professional development.

Conclusion

The story of economic development in Korea is a strong one. So too is the story of national commitment to education and national achievement in education.

But, the goal posts keep shifting, so current success is no basis for relaxing. Just as the transformation of many economies to ‘knowledge economies’ has increased the demand for higher levels of skills throughout the labour force, so demands are likely to continue to rise. Singapore seeks to become a 'thinking island’ in which economic success is built upon creativity and seeks to transform an education system that is outstanding by all usual measures of student learning into one that nurtures creativity as well as high-level cognitive skills. Korea will need to pursue similar goals and, given its strong present position is well placed to do so.

To achieve this with students will require the same of the education authorities and the schools -–the courage and the capacity to be creative.

BIBLIOGRAPHY

Arjona, R., Ladaique, M. and Pearson, M. (2001), Growth, inequality and social protection, OECD Labour Market and Social Policy Occasional Papers, No. 51.

Arnal, E.,Ok, W. and Torres, R. (2001), Knowledge, work organisation and economic growth, OECD Labour Market and Social Policy Occasional Papers, No. 50.

Lucas, R. (1988), On the mechanics of economic development, *Journal of Monetary Economics*, Vol. 22.

Maddison, A. (2001), *The world economy: A millenium perspective*, Paris: OECD.

Martin, J.P, and Torres, R. (2000), Korean labour market and social safety-net reforms: Challenges and policy requirements, *The Journal of the Korean Economy*, Vol. 1, No 2.

OECD (2000), *Pushing ahead with reform in Korea: A review of labour market and social safety-net policies*, Paris: OECD.

OECD (2001a), *Education at a glance: OECD indicators 2001*, Paris, OECD.

OECD (2001b), *Knowledge and skills for life: First results from PISA 2000*, Paris, OECD.

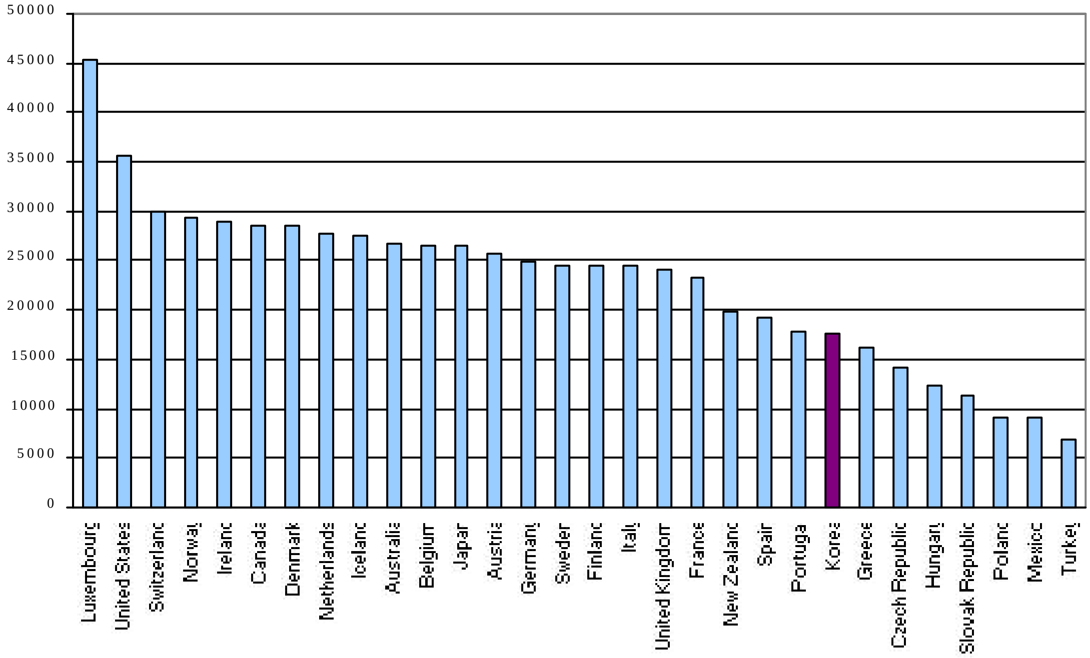
OECD (2001c), *The new economy: Beyond the hype*, Paris: OECD.

Romer, P. (1990), Endogenous technological change, *Journal of Political Economy*, No. 98(5).

Young, A. (1995), The tyranny of numbers: confronting the statistical realities of the East Asian growth experience, *Quarterly Journal of Economics*, 110(3), 641-680.

Figure 1: Living standards in OECD countries

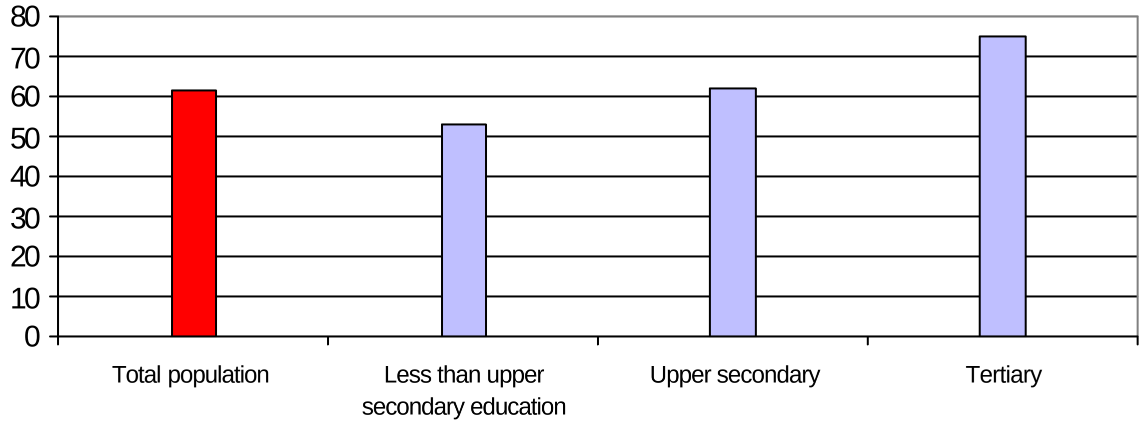
(GDP per capita, current US $, based on current PPPs, 2000)



Source: OECD

Figure 2: Education improves employment prospects

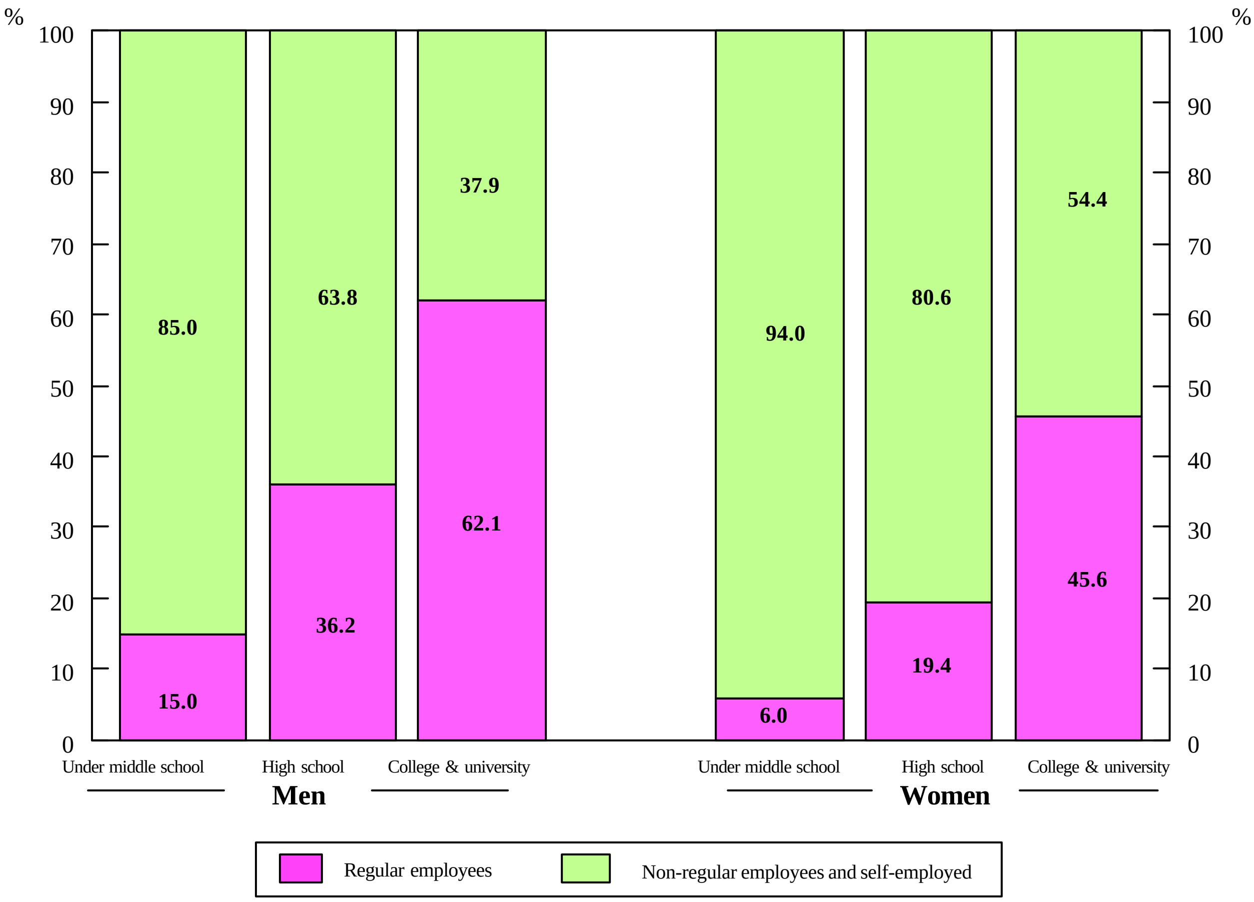
(employment-population ratio by level of educational attainment, in per cent)



Source : Korea Labour Force Survey

Figure 3: Better education for better jobs

(employment by status and by level of education in Korea, total=100)



Sources: Direct submissions by national authorities.

Figure 4: Percentage of students at each level on the PISA combined reading literacy scale

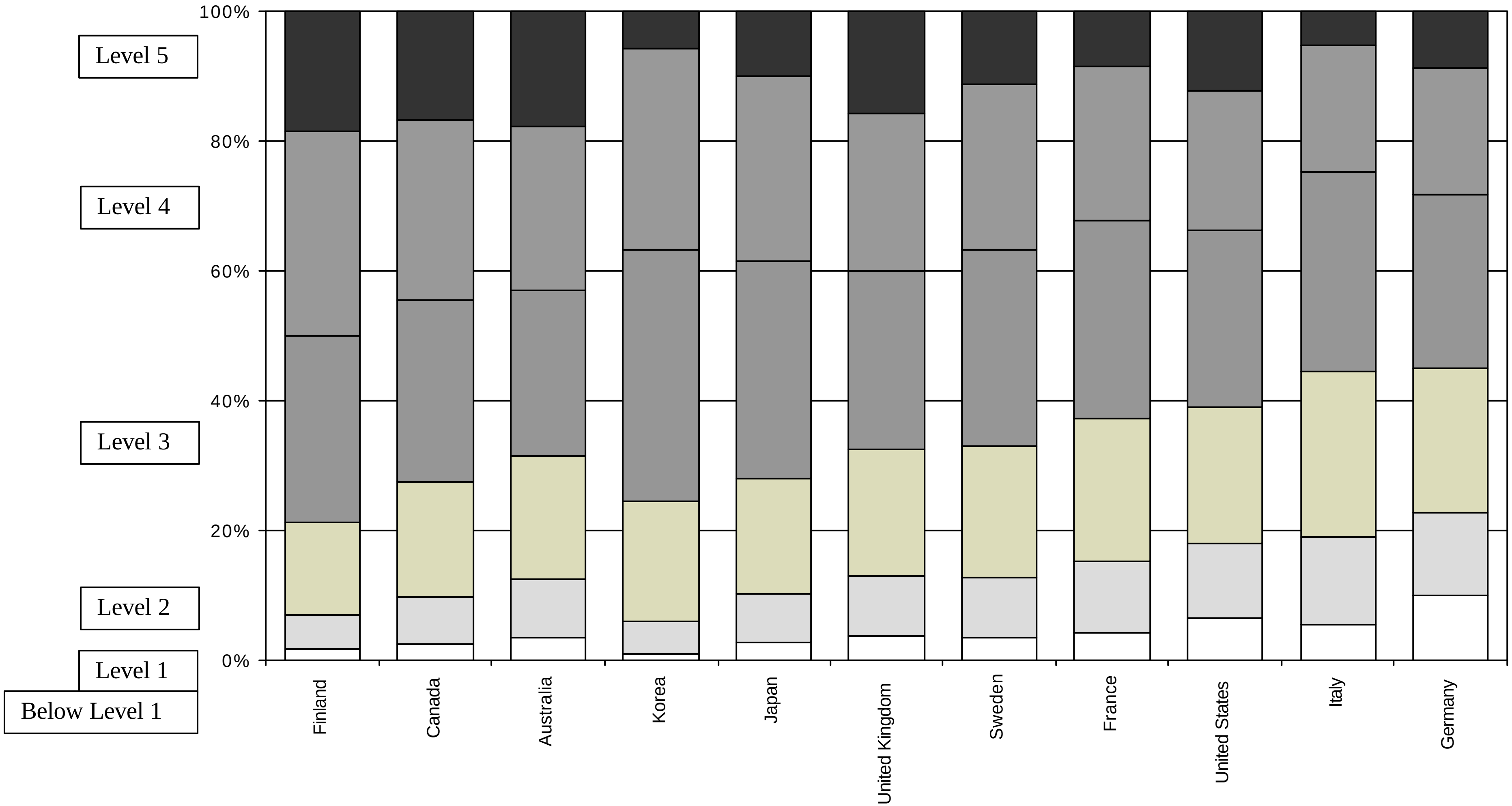


Figure 5: Relationship between students' socio-economic background and educational performance

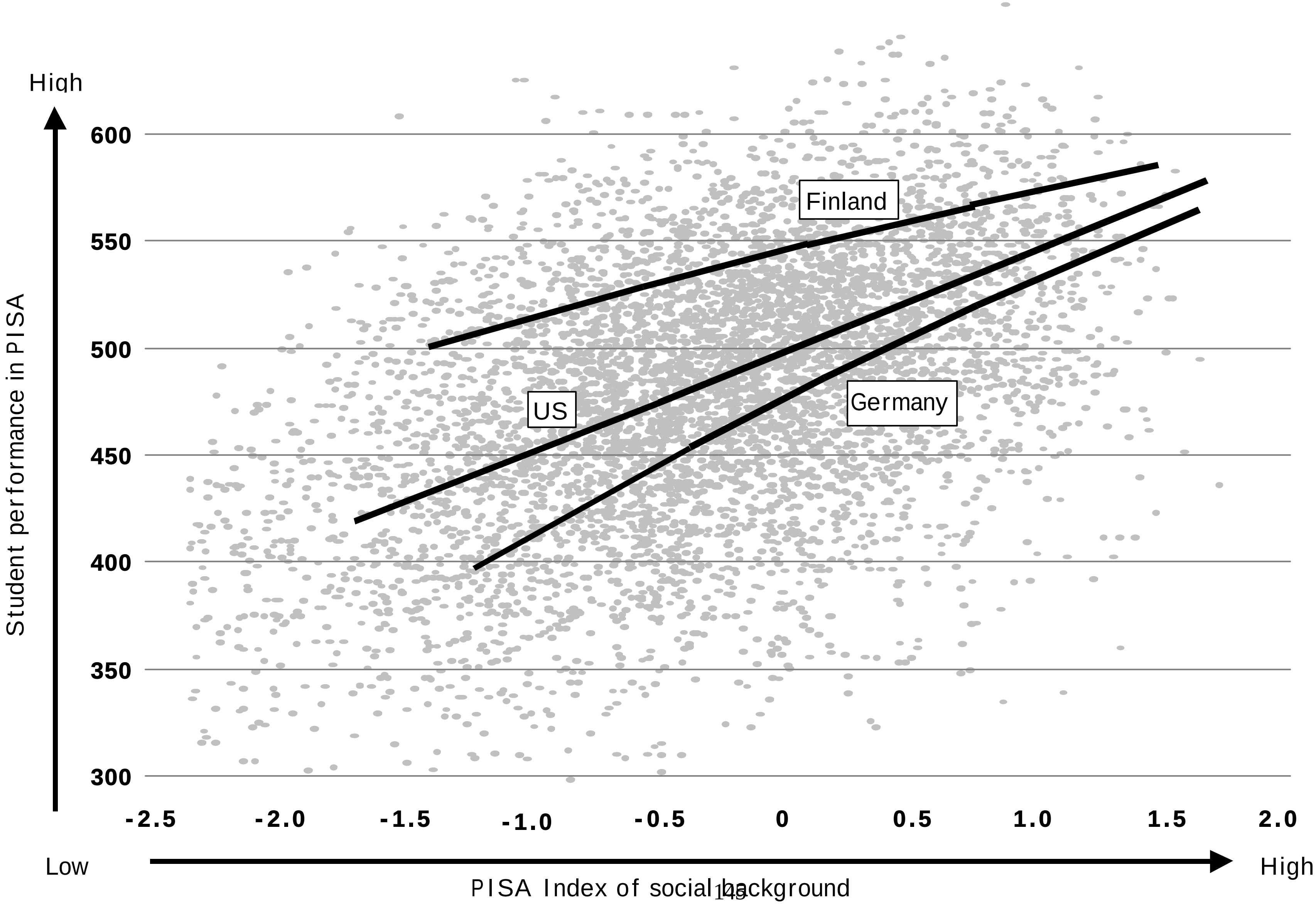


Figure 6: Growth in human capital.

Comparisons of an older (55-64) and a younger cohort (25-34)

Percentage of the cohort by highest qualification, 1999.

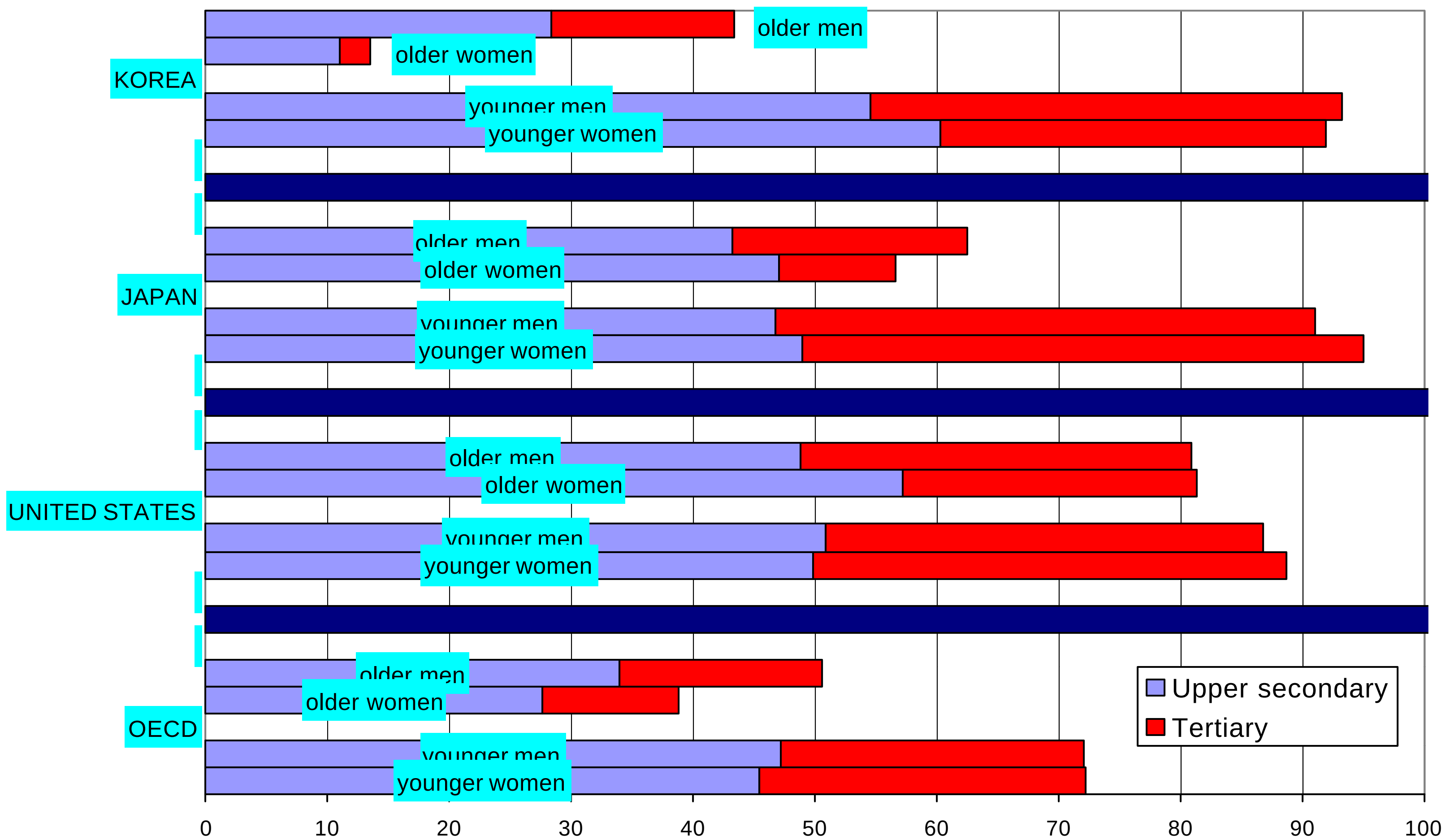


Figure7: Participation of women in employment 1999

Labour force participation rates by education level for those aged 25-64

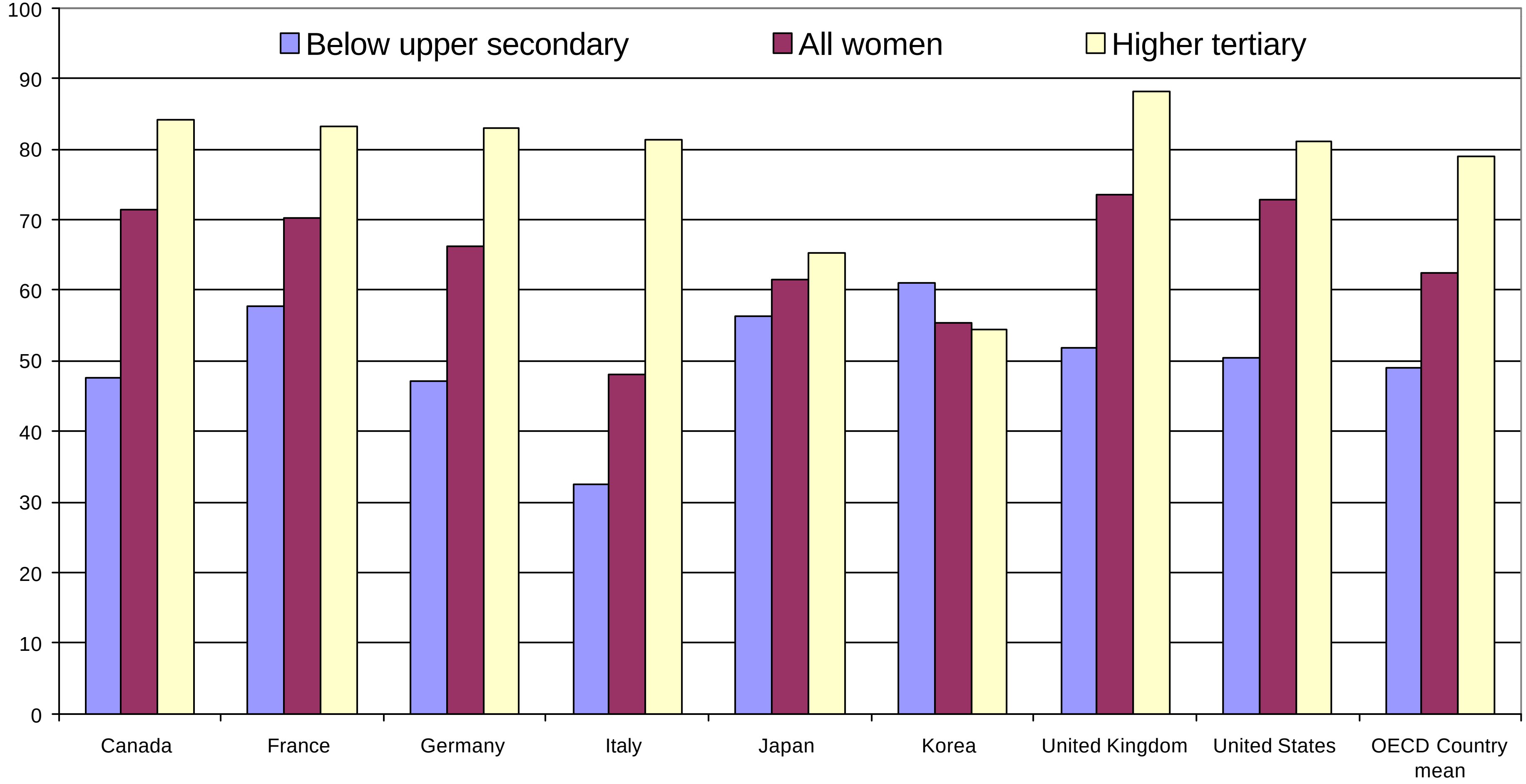


Figure 8: Wage premia for qualifications 1997-99

Earnings as a percentage of the earnings of those with upper secondary education in the same gender-country group for those aged 30-44

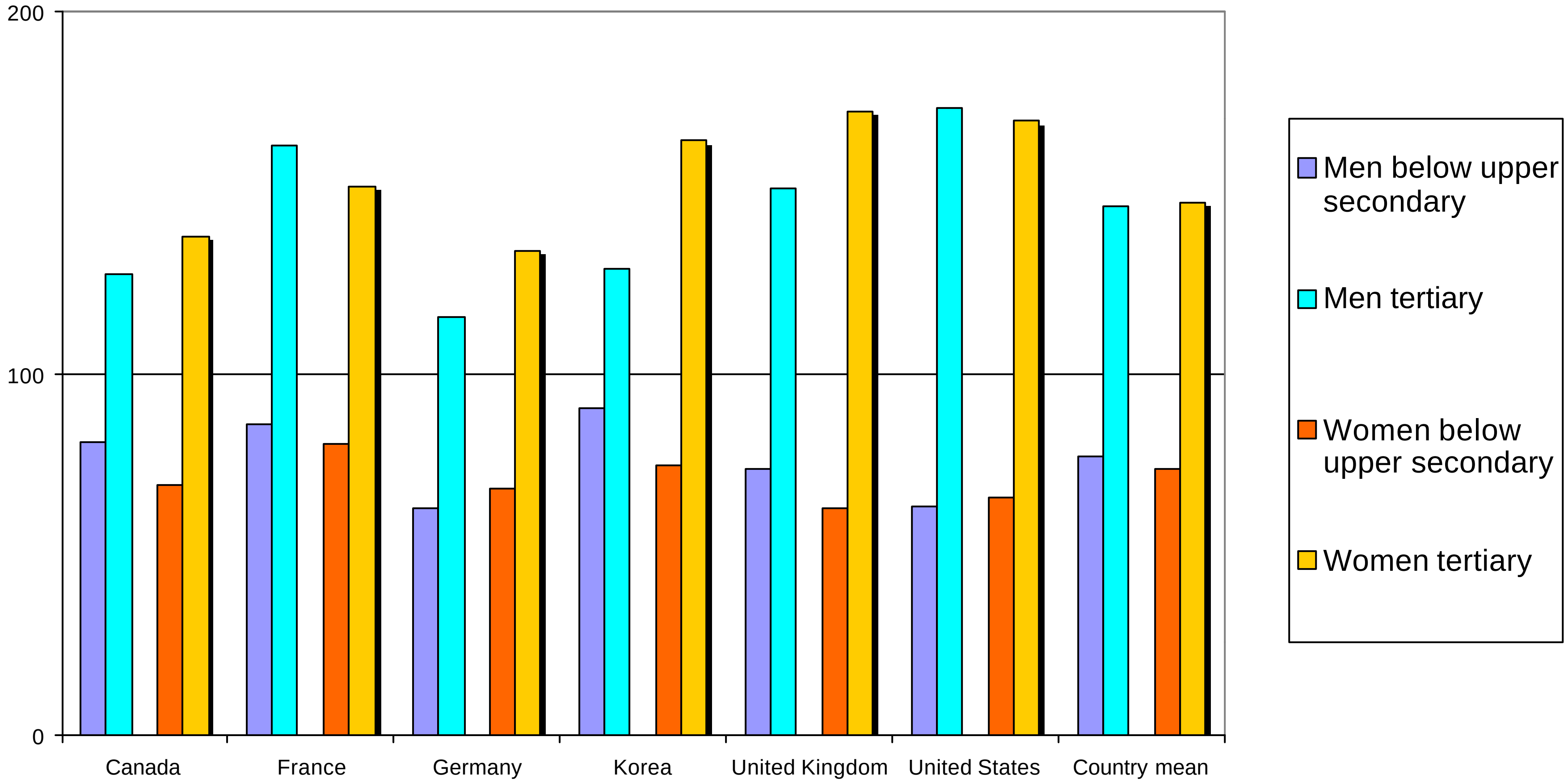
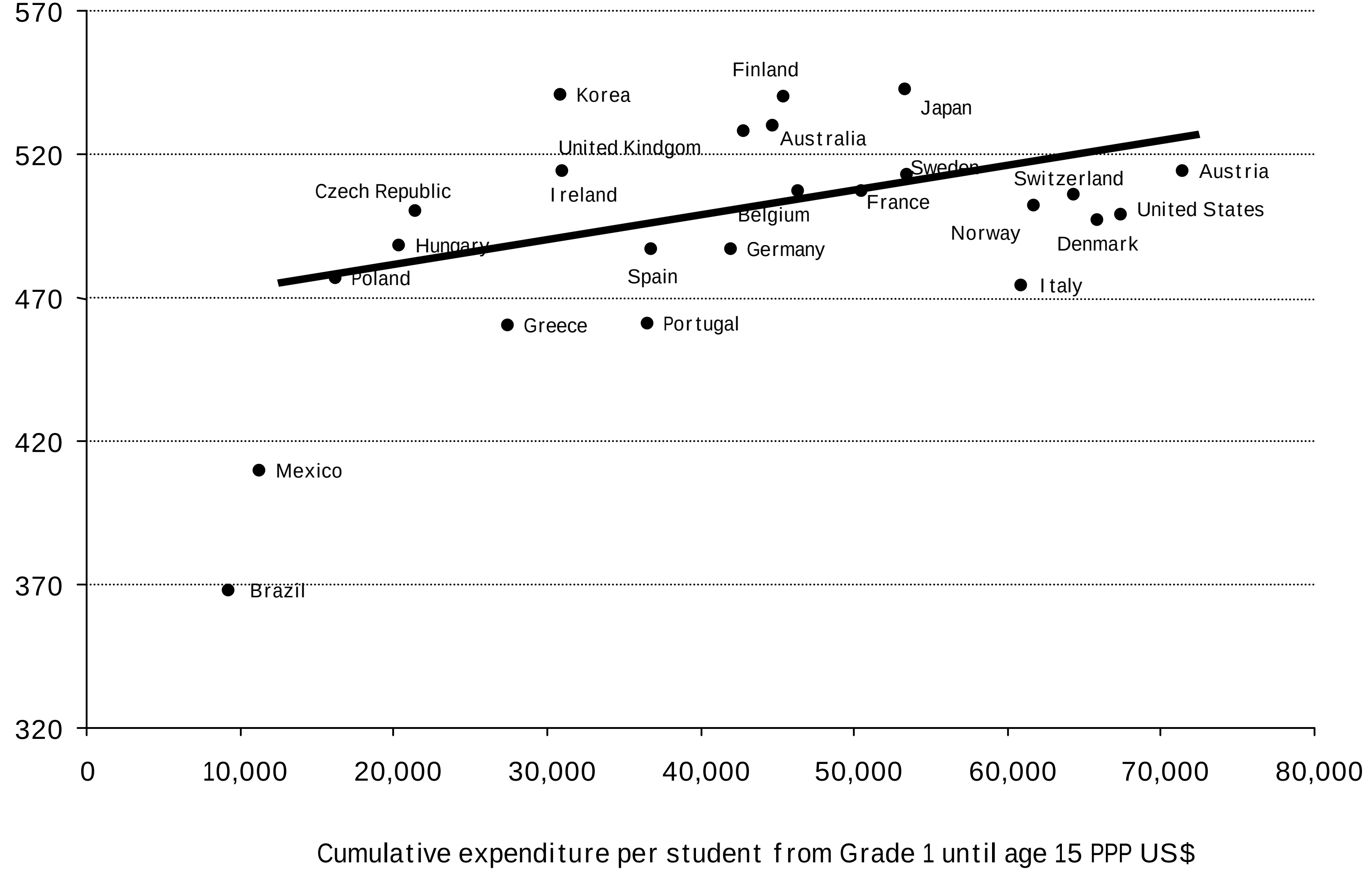


Figure 9: Relationship between average performance (reading, maths, science) and average spending per student
(from PISA report, OECD, 2001a, Figure 3.7b, p.91)



National Human Resources Development: Visions and Strategies

Soobong Uh
Director of Work Information Center
Human Resources Development Service of Korea

Based on the analysis of the future knowledge-based society and the prospects for Korea's economical and social change, this research seeks to draw up the visions and goals of human resources development from a national standpoint and to develop a systematic and integrated policy for their fulfillment.

In order to do this, the research began by analyzing the economical and social environmental change related to national human resources development(NHRD), the present condition and problems of NHRD system and the examples of human resources development system reform in major developed nations. Then, based on such analyses, visions, objectives, basic principles and basic courses for NHRD were established, and concrete policy tasks were proposed.

This research was jointly planned and promoted by the Korea Research Institute for Vocational Education and Training and the Korean Labour Economic Association. Also, in order to discuss and analyze concrete research cases and induce a policy plan, documents were analyzed, consultations as well as bull sessions were held, and policy seminar were opened. A summary of the main contents of the research is as follows.

1. Concept of National Human Resources Development (NHRD)

This research defined human resources as 'an individual's ability and character, such as information and technical skills, behavior pattern, and cultural and moral maturity, that are needed to enhance national competitiveness, organization's productivity and individual capacity for lifelong employment,' and NHRD as 'an overall national and social effort to efficiently develop (train), distribute, employ, maintain and manage human resources needed to improve national competitiveness and individual quality of life in a knowledge-based society of the 21st century.'

2. Economic and Social Change and NHRD

On examining the substances of several economic and social shocks approaching Korea considering the long-term change in the future society of the year 2020 and the impact of those shocks on its industry and labor, this research discussed the necessity of national innovation, especially innovation in NHRD system. Some examples of permanent shock factor include 1) acceleration of information accumulation and technological innovation, 2) rapid progress of globalization (Trade, Finance, Technology, Media), 3) China's emergence as a great economic power and the rearrangement in the Northeast Asia's economic order, 4) aging and stagnation of labor force supply in quantity, and 5) anxiety of digital divide.

First of all, the emergence of a knowledge-based society, where economy and society fundamentally change with the rapid creation, expansion, absorption and application of knowledge and information, led to a world-wide emphasis on enhancing individual quality of life and national competitiveness and creation, application and expansion of knowledge. In a knowledge-based society, the important factor that determines national competitiveness, corporate productivity and individual status within the labor market lies in intangible intellectual capital and innovation ability, and no longer in tangible assets such as capital and labor. Therefore, the core of national competitiveness in a knowledge-based society is to train competent men with creativity, adventurous spirit and morality, who know how to create and utilize knowledge.

Second, the emergence of "global village" as the world integrates in the 21st century has led to a paradigm transition from a previous industrial society and national economy to a knowledge-based society and world economic system. If increase in trade of actual goods through alleviation of border barriers was the main factor of world economic growth before, from now on, not only the actual goods but the production factors of labor, capital and technology, and the international exchange of service will attribute to the world economic growth through harmony in international trade as well as domestic systems, which will accelerate economic integration among the nations. Third, along with globalization, another important variable in Korea's overseas environment is China's burgeoning role as a great economic power and the consequent rearrangement in the Northeast Asia's economic order. Since the economic reform and open policy in the late 1970's, the Chinese economy has shown a rapid growth to emerge as a major economic power. Recently, China's world ranking was 7th in GDP and 9th in trade volume, while its amount of foreign capital induction and foreign exchange holding ranked second in the world. The Chinese government and World Bank forecast China's economy to maintain its progressive growth for some time, and estimate that by 2020 China will surpass the United States on the basis of purchasing power index. Therefore, it is vital to make a survey of which technology and industry holds a dominant position, and to establish a strategy in human resources development based on the findings. Furthermore, we should determine how to render useful some three million fellow countrymen in China.

Next, major cutback in working hours along with prospects of population standstill and aging by the year 2020 sheds a significant light in NHRD. That is, the yearly working hours that totaled around 2400 hrs in the year 2000 will decrease to approximately 2000 hrs in 2010, and drop to 1600 hrs by the year 2020. The stagnation in population, aging and cutdown in working hours all result in stagnation or reduction in quantity of labor force supply. This signifies that the economic growth strategy based on the increase in quantity of human resources has reached its limit. Therefore, it is urgent to secure future labor force supply (for example, expanding female, middle-aged and aged work force and employing foreign workers), improve the current labor force quality(enhancing intellectual skill) and establish a lifelong ability development system. Finally, the decrease in school-aged population will bring about higher academic background in the next generation. Since this can result in a shortage of skilled workers and secondary-level technical workers, an extensive reform in vocational education & training is essential in supplying the workers in need.

Considering the long-term view of technology and industry as well as the prospect of change in labor supply and demand, NHRD in the future needs to be innovated with the intent 1) to train intellectual technical workers for a stronger nation of knowledge-based technology, 2) to enhance key abilities of the people for a democratic welfare community and 3) to establish and expand continuing education & training system.

3. Current Situation of NHRD: A Diagnosis

This research examined the present condition and problems of Korea's NHRD system in four aspects; namely, human resources training, human resources distribution and application that is concerned with utilizing the trained human resources in the labor market, maintenance and management through reeducation or retraining of work force in the labor market and NHRD policy administration involving human resources development related systems or infrastructures.

First, in the aspect of human resources training, it was noted that distrust in school education was growing due to the standardization policy of the secondary-level education, which lacked to gain diversity in school education and failed to offer higher quality education to the excellent learners. Also, this research reviewed the problems faced by many vocational high schools as the number of students rapidly dropped, questioning their identities. Moreover, it was discussed that the international competitiveness of Korea's college education is unsatisfactory with its quality deteriorating despite its rapid growth in numbers.

Next, as for the distribution and application of human resources, the insufficient employment of female workers was pointed out as a problem. This in part is due to the distortion of the female worker training system. It was also emphasized that the imbalance among regions in work force training and supply is growing more seriously as the regional colleges, which occupy 60% of the four-year colleges, are not meeting up to their standards, and what is more, education is not sufficiently responding to the industries needs. Therefore, the discrepancy in quantity and quality within the labor market poses a major problem and it is being completely passed on to the enterprises. Joblessness among youths and the excessive number of idle youth workers, including high school graduates who are preparing for the next chance to enter college and those who are preparing for the civil service examinations, also became an issue.

Then, in the aspect of human resources maintenance and management, it was indicated that Korea's vocational training emphasized curative and compensative training more than cumulative and preventive training. The curative and compensative training, which supports the employment of the jobless people, was found to take up a larger part than the cumulative and preventive training, which aids the incumbents in enhancing their careers. Moreover, the insufficient training of vulnerable classes such as medium and small-sized businesses or irregular workers comes as a big problem. The other major concern is that the outcome of relief training for the unemployed workers is unsatisfactory due to the lack of information and consultation related to the training, and the failure to give motives to those under training.

Finally, in the aspect of NHRD policy administration, discussions were made of the fact that the centralization of every educational administration powers and all the various regulations infringe on the establishment of autonomous and creative education centering on the local schools. Furthermore, the key factors that enable proper operation of the educational and training market are the evaluation of educational and training institution and the consequent incentive or disadvantage, the guidance for those in need of education and training to make a sensible choice by making public such evaluation results, and the eventual establishment of a system that will shut down insolvent institutions. These measures, however, have not been established as one stable, systematic device, which makes it difficult to guarantee efficiency in educational and training market. For example, the certification system, which is an important means to keep in link the educational training and the labor market, was put in question because it fails to act as a sign of a worker's competence.

Because such critical problems exist within Korea's NHRD system, the policy measures to improve this situation should not be a simple, fragmentary one in order to prove to be effective. Instead, an organized and overall reform of the whole system is vital.

4. Recent Innovation of HRD System in Developed Countries

Since national competitiveness in a knowledge-based society is determined by the quantity and quality of a nation's human resources, a progressive human resources development policy on a national scale is needed to adjust to the environmental change and to gain competitiveness. Therefore, it is critical to establish an innovative system through an organic cooperation among the main bodies of human resources development, namely the community, the private sector, the academy and the research institute. In this research, national innovation system and examples of human resources development innovation of the developed nations were analyzed so as to extract the key points of NHRD policy innovations.

The establishment of national innovation system signifies a transition to a system where creation, application and expansion of knowledge are easy. It also involves increase in the absolute quantity and level of the key production factors, such as human resources and capital, as well as improvement in every system for an efficient utilization of such factors. National innovation system can be analyzed in three factors: 1) interactions among the research bodies: interactions of sharing and expanding knowledge and technology among the research bodies; 2) technology infrastructure: accumulation of knowledge and technology; 3) governmental research and related human resources development policy: supporting progressive bodies and their members through the promotion of various governmental policies.

New role of the government, making of innovative culture, support for technology expansion policy, expedition of networks and groups, promotion of research development and preparation for globalization were suggested as the policy goals for national innovation system. Also, this research identified the implementation of educational training policy based on the demand change, application of human resources for an improvement in the relationship between the academy and the industry, and improvement of infrastructure to increase the contributions made by science and technology workers as major human resources development policy measures for such national innovation

Through the discussions on national innovation system, examples of the advanced nations' innovations related to changes in human resources development system, such as education and labor policy, were compared and analyzed. The study focused on the roles and systems of the government and the private sectors, central and regional governments, vocational education & training-related systems and changes, education, R&D and the labor market and employment policy-related changes.

As a result, it was found that the developed nations devised and implemented human resources policy taking into account the environmental changes, established and implemented demand-oriented systems and policies, enforced high-level and continuing educational system, clarified the role of the government while enforcing its support system, and stimulated the private sector through incentives.

5. Visions and Strategies

Based on the above mentioned economic and social environmental changes of a knowledge-based society, the present condition and problems of Korea's human resources development system and the analysis of the examples of human resources development system innovation in major advanced nations, the visions, objectives and policy tasks of NHRD were suggested and discussed in order to devise a new policy for human resources development. The visions and objectives were proposed respectively in aspect of the state, the society, the organization and the individual. In result, the visions set for NHRD are to build a nation strong in knowledge and technology, to accomplish a democratic welfare community, to realize the ideology of an organization, and to improve the individual quality of life. Correspondingly, enforcing national competitiveness, establishing a social welfare system through learning and working, increasing organizations productivity, improving individuals capacity for a lifelong employment and self-realization were presented as the objectives of NHRD.

In the meantime, these visions and objectives called for the need to change NHRD paradigm, and the basic principles for its policy were put to discussion. As for NHRD paradigm, it was examined that the government needs to enforce its duties in strategic arbitration, evaluation and support, while the educational and training administration needs to be centered on the workers with decentralized system that is run by institutes and open to public. It was also noted that the administration of human resources development system should emphasize not only training but also distribution, application, maintenance and management, and quality improvement.

Moreover, some of the basic principles presented for the establishment and implementation of NHRD policy are to increase efficiency, enforce accountability, pursuit innovation, enhance equity and impartiality, guarantee comprehensiveness and systematic plan, and maintain consistency.

Based on the previous discussions, the basic courses of NHRD policy were identified, which included cultivating peoples fundamental and key abilities, innovating the training of intellectual, technical and specialized work force, increasing efficiency in management and application of human resources, enforcing human resources development in vulnerable social classes, and constructing and administrating NHRD infrastructure. Each of these basic courses acts as an individual field of major policy making, and these need to be attained first in order to achieve NHRD visions.

According to the five basic courses set for the realization of NHRD visions and objectives, 25 policy tasks were proposed, each examining its needs, policy measures and expectation effect.

First, in relation to cultivating peoples fundamental and key abilities, eight policy tasks were presented, which were 1) expanding students' school choice, 2) increasing local schools' autonomy and responsibility, 3) setting a national academic standard for basic schooling and its regular evaluation 4) enhancing expertise and field relevance of the development and administration of educational curriculum, 5) upgrading the quality level of teachers, 6) reforming vocational high school system, 7) innovating guidance education service, and 8) enforcing democratic civic education.

Second, as for innovating the training of intellectual, technical and specialized work force, 1) expanding development of high-level workers in cutting-edge and strategic areas as well as in R&D, 2) fostering regional foothold of knowledge, 3) higher education system innovation, 4) globalization of education and research, 5) establishment and operation of in-service training system for grown-ups in higher education institutes, and 6) improving college evaluation and quality management system were pointed out.

Third, policy tasks 1) to set up a support system of lifelong occupational competency development for workers, 2) to stimulate the development and application of work force in the civil service and professional fields, and 3) to nurture female workers and expanding their employment, were presented in relation to the goal of increasing efficiency in management and application of human resources.

Then, as the means to enforce human resources development in vulnerable social classes, expanding opportunities of human resources development for 1) the handicapped, 2) the middle-aged and aged workers and 3) low-income class and irregular/unemployed workers was raised as an important task, and at the same time, 4) the need to train these classes to access information was emphasized.

Finally, in relation to the construction and administration of NHRD infrastructure, major policy tasks presented were 1) improving the system that links the educational and training market and the labor market, 2) redefining the roles and functions of the main stakeholders related to NHRD, 3) setting up and operating an overall information system concerning human resources supply and demand, and 4) establishing a support system for individual lifelong learning.

Comment

Hyehoon Lee
Korea Development Institute

It is an honorable opportunity for me to read very insightful papers and present my commentary note in this conference. Two papers, "The role of human capital in long-term economic growth" and "National Human Resource Development: Visions and Strategies", address the importance of human capital in sustainable economic development. The former examined educational system in Korea as one of main tool for human capital development and raised some issues for improvement based on his findings. The latter summarized very comprehensive research on national human resource development. The author overviewed major future challenges the Korean economy will face, stressed the importance of National Human Resource Development (NHRD), reviewed the current system of NHRD in Korea and other OECD countries, and then finally suggested visions and strategies for NHRD.

My comments are to neither disagree nor criticize those papers, but to supplement and reinforce the argument. First of all, both papers mentioned the importance of ageing trend in developing human capital to support the economic growth. I would like to emphasize its importance to greater extent than those papers did.

Ageing will affect human capital when it combines with rapid progress of information and technology. As life expectancy prolongs, people will have longer period with obsolete knowledge or skills that was acquired in their young age. As the proportion of the elderly grows, the proportion of the people not equipped with adequate knowledge or skills demanded by the market. Thus, national competitiveness will be hampered unless effective measures to reeducate the elderly are implemented.

Nevertheless, reeducation or retraining programs for the elderly are currently very poor in Korea. Average retirement age in Korea is around 55 years old, even though delaying retirement is one of key strategies to sustain economic development in an ageing society. Such a low retirement age is partly resulted from poor productivity of the elderly compared to their wage. Productivity is closely related to human capital embedded in individual workers. Without reeducating or retraining the elderly workers, it seems less likely that we may sustain the economic growth.

We expect that Korea will experience remarkably fast aging in the coming decades. The proportion of the elderly over 65 is currently around 7%, but it will grow to about 14% in 20 years. It means that only 20 years will be taken for Korea to transit from an aging society to an aged society. Such transition took almost a century in other OECD countries. Fast aging leaves less and less time for adequate reform to alleviate expected detrimental impacts of ageing on human capital. This is why Korea should immediately embark on reforms to foster reeducation or retraining services for the elderly.

Secondly, I would like high light the importance of women in sustaining economic development. As Dr. Uh pointed out in his presentation, we need female labor as a new driving force of the economic growth. As many economists argue, input driven growth of the Korean economy may not continue in the coming decades if we rely on male labor only.

Nevertheless female participation is too low in Korea compared to other countries. Only 56% of the female university graduates are participating in the labor market while 83% is OECD average. Even in case of employment, female workers are hired for position that does not demand professional skill or knowledge. 55% of the female workers who received tertiary education are working as temporary workers. Only 0.3% of the female workers have position of manager, higher level officer, or CEO. It is remarkably low compared to 14% of the US and 6.3% of Singapore.

Human capital invested in female labor is not fully utilized to enhance the competitiveness of the Korean economy. In order to sustain economic growth by developing human capital, it is crucial not only to ensure lifelong learning for all but also to remove various obstacles to female employment.

Comment

Deok Soo Kong
Director-General, International Cooperation Bureau
Ministry of Labor

■ *Advent of the knowledge-based economy era and changes in labor market*

○ The digital revolution including the wide-spread use of computers and internet has recently transformed the traditional industrial society into a knowledge-based one in which knowledge determines the competitiveness and success of individuals, companies and nations. It means that knowledge and information are becoming essential factors in determining nations' competitiveness, companies' productivity and individuals' labor market status.

○ The transition to a knowledge-based society is inevitably bringing about changes to industrial structure and labor market.

- There will be a rapid increase in demand for manpower in information, communications, knowledge services industries. Shifts between jobs will increase with the spread of new products. Labor mobility will also increase due to frequent job creation and elimination.

- Employment and recruitment types are expected to diversify further, as non-standard work such as dispatched work and work at home will continue to increase thanks to growing labor market flexibility and development of information technology.

※ Proportion of temporary, daily workers : 41.2% in 1993, 51.7% in 1999, 52.0% in Sept. 2000

- Wage disparities will arise depending on whether workers have an ability to use information and computers and on how they manage their skills and careers. Rapid changes in technologies will make it more difficult for new college graduates to find jobs. Social and economic problems caused by digital divide will intensify in the future.

○ In Korea, the IT industry also has grown at an annual rate of 31% on average since 1998. Last year, the total output of the IT industry amounted to 141 trillion won, accounting for 12.3% of GDP.

- It is expected that workforce in core and non-core IT occupations will rise 26% and 12%, respectively, over the next five years.

- Korea has experienced a shortage of 40,000 manpower in IT industry in 2001. If this trend continues, it is expected that there will be a shortage of 180,000 manpower in IT industry by 2005.

■ Policy Directions

○ Today, all the countries of the world are making every effort to develop human resources with a view to becoming knowledge-based economic powers in this new century.

- The Korean government is also actively working to foster knowledge workers with intellectual creativity and new skills applicable to the new industries emerging in the New Economy, industries essential for national competitiveness.

1. Establishment of the HRD system in response to labor market demands

○ Based on systematic workforce demand prospects, the government plans to focus on nurturing professional workforce for new industry fields with large market demands and high added value.

○ To this end, the government has strengthened the function of the public sector in educating professional knowledge workers by reorganizing curricula in 22 Polytechnic Colleges and vocational colleges across the country into knowledge and IT related occupations and by newly establishing IT Polytechnic Colleges.

- Also, the fostering of manpower will be strengthened in high-tech industries such as IT. A change in education and training method will be made from the current supply-oriented to demand-oriented one and a systematic cooperation system will be established between businesses, schools and research institutes.

2. Establishment of the support system for lifelong HRD.

○ With an increase in labor mobility in the labor market, companies' demand for skilled knowledge workers will increase while workers will put more emphasis on self-development in pursuit of employment security and high income.

○ To cope with this, the government(the Ministry of Labor) will

- establish and support 'training consortium' in order to help human resources development in small and medium enterprises;

- transform public training institutions into 'lifelong ability development centers' and conduct demand-oriented open training; and

- strengthen cyber training easily accessible over the internet at any time and from any where by making use of digital environment.

- The subsidies for taking classes, intended to support training expenses if workers receive vocational training by choosing their own training occupation, will be expanded to apply to any workers in workplaces employing less than 50 workers.

3. Pursuit of HRD through partnership between labor, management and the government

○ In a knowledge-based society, it will be not only realistically impossible for the government to be exclusively involved in human resources development, but it will undermine the effectiveness of policy implementation.

○ Therefore, labor, management and the government will have to share their views and concentrate their respective energy on this matter. To do so, companies should take the initiative in human resources development based on cooperation between labor and management, while the government should focus on increasing opportunities for ability development and training to foster both knowledge managers and knowledge workers.

4. Promotion of participation of private sectors in HRD

○ Because human resources development policies led by the government alone have their limits in the knowledge-based economy, it is necessary to establish a partnership with private sectors.

- For this purpose, the government has established an evaluation system under which feed-back on HRD policies is given through participation of private sectors in human resources development.

- The government has had private sectors provide training tailored to their needs and particular circumstances.

5. Establishment of HRD infrastructure

○ To ensure the rapid and effective distribution of information on human resources, education and training, the Employment Information Highway will be built, enabling the integration of various employment information from various organizations into one system. Also the government will develop various indices indicating a trend in HRD and a prospect for supply and demand, reflect this information in policy-making and increase the output of information on human resources (including the improvement of HRD-related statistics).

■ Closing remarks

○ HRD policy in the upcoming information age is one of the very important strategies which present a vision of a nation in the 21st century as well as the national economy. Recognizing that the success of national development depends on human resources development in the knowledge-based and information age in the 21st century, Korea will do its utmost to foster and develop knowledge workers by steadily pushing forward HRD policies mentioned above.

Comment

Jong-Wha Lee
Professor of Economics Department
Korea University

It is indeed an honor for me to participate in this important conference. Two papers have raised many important issues related to the development of human resources for sustainable long-term growth. I quite agree with two authors on many points they emphasized. Hence, my comments are rather supplementary to them. I will address two issues.

First, I want to emphasize that human capital is important not just because it is a productive factor, but also it helps to facilitate technological development. Sustainable growth must require both technology and human resources.

Technology is widely considered to be a crucial factor of input in economic development of countries. Recent studies on economic growth emphasize that technological progress plays a pivotal role in sustained long-term growth. Empirical evidence has also shown that technology accounts for a major portion of cross-country differences in both the level and growth rates of income.

But, technology progress does not occur automatically. The extent and speed of technology development depend on the domestic capacity of creating own new technologies or absorbing advanced technologies from abroad. Human capital renders the most important capacity for technology creation and adaptation. The development of new technologies requires human efforts and capabilities that cannot be just granted. New technologies often require new skills. That is, without the appropriate investment in human capital, advanced technologies cannot make developing countries grow at a rapid pace.

Hence, human resource becomes more important in changing technology environments. The revolutionary development of modern information and communication technologies has had a powerful impact on productivity growth in an economy. The ICT industry itself has developed at the highest rate of innovation. This in turn has made firms and markets work more efficiently by fostering greater networking in all sectors of the economy, thereby contributing to productivity growth in the overall economy as well.

The diffusion of new ICT technologies accelerated worldwide in the 1990s, especially after 1995 as the Internet-based technologies such as the World Wide Web and the browser spread rapidly. Yet at present, the developments are heavily concentrated on a few countries.

There must be several constraints that prevent a country from reaping the benefits from the new ICT technologies. Lack of financial resources is one major factor that restrains information and communication investment in developing countries. Building ICT infrastructures require vast amounts of investment. But, in addition to financial constraints, human capacity is a key factor that restrains the development of ICT. Even if free computers and free Internet access are available, they are useless to those individuals who are illiterate or lack the know-how. The application of ICT technologies requires human capabilities to handle such technologies.

Second, concerning the strategy of developing human resources for sustainable long-term growth, I would like to emphasize that we need to focus on improving the quality of schooling. Increase in educational quantity alone is not enough to meet the changing demands for high skills. Sufficient quality of education is needed to produce the graduates possessing various cognitive skills that can increase their productivity in the labor markets of the future.

It is not an easy task to improve schooling quality. School factors as well as non-school factors, such as family and cultural environments, affect the quality of education. Empirical evidence based on micro data, shows that family inputs, such as income and education of parents, have strong relations to student performance. Most empirical studies, though not always conclusive, support the notion that resources available to the students in schools also influence student achievements. More school resources- especially smaller class sizes and higher teacher quality- enhance student achievements in mathematics, science, and reading literacy tests.

Improving educational quality also involves improving the efficiency of educational systems. For the improvement of schooling quality, both the level and effectiveness of educational inputs should be increased. Strengthening managerial and institutional capabilities throughout the educational system will be essential in the success of these efforts. I consider that Korean education system is too much centrally organized. This centralized system leads, in many cases, to inefficient allocation of resources. Reducing bureaucratic control and increasing the independence of schools can be an alternative route that leads to a better organization of education. Promoting competition among schools, perhaps by increasing liberty of parents and individuals in school selection, can have a positive effect on the quality and performance of schools.

It must be emphasized that the improvement of quality of human resources can not be achieved without efficient social system. In Korea, human resources are still poorly allocated and managed because of wrong incentives given by the social system as a whole. For instance, many bright human resources are wasted to study bar or high civil service exams The social system itself needs to change in order to enhance the efficiency in the allocation of human resources in Korea.

Comment

Kisung Lee
Director, International Studies and Cooperation Team
Korea Research Institute for Vocational Education and Training

▶ Introduction

Dr. Uh's paper dealt with the concept, current situations, and future directions of NHRD. More specifically, the paper explored the concept of NHRD briefly describing the context in which the concept emerged, discussed four areas that constitute on Korea's NHRD system, discussed efforts made by developed countries to innovate their HRD system. Finally, the paper presented visions and workable strategies from what the researchers had examined.

Revisiting the definition of NHRD

- ASTD: A set of purposeful, planned, and systematic learning activities to enhance the individuals', groups', and organizations' efficiency through integrated process of individual development, organization development, and career development.

- Patricia A. McLagan: Integrated process of training and development, career development, and organization development for improving effectiveness of individuals, groups and organizations

- The Ministry of Education and Human Resources Development, Republic of Korea: Social efforts, including improvement of system and institution, carried out nation-wide in the areas of education, training, and other cultural activities with the aim of effectively developing and utilizing the nation's human resources.

▶ Main points

The Korean government focuses on the development of 46 million Koreans, from children to senior citizens.

The concept of NHRD is required for survival in the global competition, especially in the midst of the dramatic emergence of a knowledge-based society, globalization, changes in the world of work(eg., cutback in working hours) and reduction in labor force supply.

Examination of cases in developed countries suggests that Korea should innovate its national system of human resources development to foster participation of all stakeholders.

▶ Some considerations

Is it possible for a country to develop all of its people?

If it is possible, the following should be considered:

· Clear division of labor among stakeholders, namely the government, private enterprises, and individuals: A line should be drawn as to what extent the government will be involved and will not be involved in providing vocational education and training for adults. Overlapping of roles among stakeholders can result in serious conflict.

· Priorities in meeting needs for vocational education and training: It must be decided which sector, how many workers, how long, where, etc. the workforce needs to be trained, developed, allocated, etc.

· Securing the necessary budget and staff

Examine many best practices of developed countries developing human resources, innovating systems, making appropriate legal provisions, and so on.

Silly but more profound, philosophical question:

· Are changes in the economic environment the main factors in pursuing NHRD?

· If human resources development is pursued by the government on a national level, will quality of life be enhanced? Will more people find happiness?

Recently many people are worrying about the decline of humane studies, pure studies such as literature, history, mathematics, etc.

· We need to take into account that our reckless pursuit of new, state-of-art technology may backfire at us with the collapse of pure humanities studies, on which our civilization is built.

Comment

Sung Whan Choi
Senior Economic Writer
The Chosun Ilbo

Right after the 1997 foreign exchange crisis in East Asia, McKinsey & Company said that they were surprised twice in following the Korean case. Firstly, they were surprised to find that there were so much research analyses and reports, which had raised and warned the problems of Korean economy. Secondly, they were further surprised that not only Korean government but also the Korean firms or financial institutions did not take any proper measures to cope with those problems.

The exactly same analogy goes to the Korean education system. Many analyses and problems raised but no proper measures to take. The reason for the education being the number one national agenda is that the education is one of the most important determinants of long-term economic growth. This point is well stressed in Dr. McGaw's detailed and tangible paper.

Now let me describe the current situation of Korean education by giving you an interesting but somewhat bittering comparison of college students between US and Korea. There is a Silicon Valley in the neighborhood of Stanford University where as there is a state examination valley in the neighborhood of Seoul National University.

In one sense, they are the same in that the lights are going on days and nights. However, they are totaly different if we look into the inner circle. In the Silicon Valley, students, graduates and professors, all they work hard to create or invent the new technologies and thus pioneer the future of the human being. Besides, they earn the huge money as an incentive when they succeed.

But in the state examination valley of Korea, they also work harder than anyone else but only to pass the state examination. They do not crate or invent anything. They only memorize the numerical fomular or the text of the regulations, which means that they are devoting to dig into the past and at most present or current form. When they pass the examination, they are guaranteed to make a relatively comfortable and easy-going living on other people's tax and creation, if any.

With this in mind, which country has brighter and promising future? I do believe the answer would be one-sided and almost unanimous. As I said in the beginning, there are many, too many analyses and answers to reform the education system in Korea. Their focuses are mainly on the system of K-12 and/or colleage education, which Dr. Soobong Uh well mentioned, and diagonized in his paper. Among them, the entrance examination of college and the standardization of the high school or secondary-level education are the most notable reform areas.

Today I am going to take a somewhat different approach: the abolition of the state examination. Unless the state examination is abolished, I dare to say that all other reform measures would be less effective and sometimes useless. Not only the students of arts and social science but also the students of engineering and natural science all together aim for the state examination. Only exception would be the medical and dental students. We need a kind of top-down style remedy: if the college education becomes normal by abolishing the state examination, high school education can be easier to normalize and so on.

Before closing, I want to give you two unproven but persuasive examples which may show how important the young educated generation for the longer-term economic growth. During the First World War, more than 600,000 young soldiers of the United Kingdom had lost their lives. Many of them were from Cambrige, Oxford and other prestigious colleges from all over the world and, after the WW Ⅰ, the United Kingdom slowly became the second-class in the world economy.

On the other hand, during the WW Ⅱ, Japan gave the exemption from the military services for the students and graduates of engineering and natural science. After the WW Ⅱ, those suviving young engineers and scientists became the founding basis to rebuild the war-defeated nation and jump to the number one factory in the world. As we are approaching the so-called knowledge & information age, the human characteristics of an economy will become more and more apparent.

Finally, I would like to ask the Korean government to draw the national consensus and its strong will to stick to the principle and to implement the reform plan. We want no talks but actions.

CLOSING SESSION

Korea's Five Years in the OECD: Finding a New Path

CLOSING REMARKS

William Witherell
Director for Financial, Fiscal and Enterprise Affairs
OECD

Yesterday and this morning we have discussed Korea's interaction with the OECD in the key areas of economic policy, competition policy, financial reform and human capital development. The "new path" Korea has been following since the financial crisis clearly has a close relationship with the basic thrust of OECD's policy recommendations. This discussion demonstrated that Korea has been very conscious of the main benefits that its OECD membership brings: a vast comparative experience and expertise on policy issues, whose main depository is the OECD Secretariat and its Committees and other Groups; and also the opportunity to "drive" a peer process at a global level and thus gain international political visibility. The effort to take full advantage of these benefits should continue, even as we get further from the crisis. (Other comments on the papers may be inserted here).

The OECD has a number of interesting and challenging policy issues on its agenda. As OECD economies become more interdependent -- bound together by an ever-increasing number of linkages -- the efficiency of individual countries' policies is reduced -- international co-operation becomes more important -- indeed essential. The OECD work programme is characterised by a number of basic, priority themes of which I have time to mention only a few:

1. Economic growth; stability and structural adjustment

The basic work on macroeconomic and structural policy analysis -- one of the principal strengths of the OECD -- will feature an in-depth look at the issues of migration and of the effects of competition on economic performance. This latter work will have a wide coverage including regulatory influences on competition in product markets, factors such as state aid, trade policies, institutions and regulations in labour markets and financial market structures and policies. These are subject areas which will be of considerable interest to Korea and also where Korea's recent experience with reforms will be of great interest to other members.

2. Sustainable Development

The OECD Ministers have indicated that sustainable development must be an overarching goal of the OECD governments and the Organisation. OECD's work under this heading will continue to go beyond the political statements one often hears on this subject and develop operational strategies for the three dimensions of sustainable development: enhancing growth, promoting human and social development and protecting the environment. The emphasis of current work is first, to develop agreed indicators, to measure progress in these three dimensions of sustainable development. This will facilitate peer review processes to monitor and promote reforms. Second, we are seeking to identify how best to overcome obstacles to policy reforms, in particular the better use of market-based instruments such as environmental taxes and to the reduction of environmentally harmful subsidies. Third, we are analysing further the social aspects of sustainable development -- this includes the work on human capital discussed this morning.

3. Governance and international standards

Strengthening effective and coherent governance -- both public and corporate -- remains a priority on the policy agenda for the OECD as a whole and for Korea. The effective performance of democratic institutions, and the fight against corruption are central elements of good governance. Enhanced openness, transparency and accountability should become guiding principles for all our governments and our private institutions. Regulatory reform work will continue reflecting the recognition that carefully designed policies enhance regulatory quality, strengthen consumer choice and reduce prices. The fight against corruption, of course, must also continue with monitoring of the implementation of the OECD Convention and further work to assist countries outside the OECD in their valiant efforts to deal with this serious problem undermining developing efforts in so many countries. The important work on promoting improved corporate governance will result, inter alia, in the release in 2003 of a "white paper" for the Asian region -- an agenda for corporate governance reform agreed by the participants in the OECD -World Bank Corporate Governance Roundtable for Asia.

The corporate governance work is based on the framework provided by the OECD Principles of Corporate Governance, which have become the global standard on this subject and are being promoted by an IMF-World Bank-Financial Stability Forum effort. It is an example of "standards-led reform" which is a major feature of the evolving "New International Financial Architecture". These efforts are largely guided by the major players that meet in restricted groups like the G7, G10, and the Financial Stability Forum. The OECD plays a role in these groups (I participate in the FSF, for example) and thus through the OECD Korea is able to have somewhat greater influence on such financial discussions than it did before accession.

4. The Multilateral Trading System

The new multilateral global round of trade negotiations, officially named the Doha Development Agenda, has been launched. Korea, as the 13th largest trading country in the world, has a great interest in trade liberalisation and the outcome of these negotiations. The OECD will play a major role in helping Members and also non-Members prepare on the various issues through what we call a "non- negotiating" policy dialogue. Of particular use to Korea should be the OECD's efforts to develop a better understanding among all parties, including civil society, of what is at stake. We are convinced that multilateral trade liberalisation and a strengthening of trade rules are fundamental for sustainable development and a major driving force for innovation, growth and enhanced human welfare world-wide. We need to find effective ways to put this message across.

5. OECD work relating to mitigating the impacts of international terrorism

Finally, I would like to mention several of the ways the OECD is contributing to dealing with the aftermath of the terrorist attacks of September 11. These show the rapid way the Organisation is able to respond to new, unexpected needs of our Members and some of this work will be of direct interest to Korea.

At its meeting of 12-13 November, the Economic Policy Committee had a first discussion of the implications of terrorism on OECD economies. Committee members considered that the consequences were potentially widespread, especially on productivity. The Economics Department will develop a framework for analysis of economic impacts related to terrorism risk or actions to fight terrorism. This will cover, for example, the increased cost of transboundary shipments and impacts on international trade; impacts on insurance markets and consequent costs; impact on costs of financial transactions; problems in the aviation industry; the fall-off in international tourism; consequences for international migration and economic spin-offs; or the risk for emerging and developing economies of losing access to OECD markets, including capital markets, under reasonable terms. The resulting assessments of the merits of the economic and systemic impacts will provide a basis for recommendations that should assist in drawing lessons for fiscal, monetary, structural and regulatory policies. The process should also provide occasions to discuss and identify different policies or “best practices” for dealing with particular impacts or costs.

The OECD Insurance Committee recognises that action is needed urgently to avoid a shrinkage of affordable insurance for terrorism risks and prevent knock-on effects on economies. Actions will be taken at the national level, but international consultations can help strengthen risk transfer and sharing mechanisms necessary to match these global terrorism threats. Three main actors must work together: governments, the insurance and reinsurance industry, and the financial markets, these latter for the development of improved risk transfer techniques. Governments will need to continue to assess how their role should evolve in order to ensure the proper functioning of market mechanisms. The Insurance Committee (whose members account for some 95 per cent of world insurance markets) is holding a special session on insurance coverage of terrorism risks today and tomorrow in Paris and the first results of its analysis should be available next Spring.

Conclusions

These are just several of the major themes of OECD’s ongoing work. Many elements of the work program will be relevant to Korea’s ongoing reform efforts and the future challenges it faces. Among these challenges will be reform of the tax and pensions systems, the unfinished reforms of the financial and corporate sectors, the continued battle against corruption, the on-going transformation from an industrial economy to an information-based economy – with its implications for the educational system, addressing the problems due to the extreme geographical polarisation of the population and production, and, eventually, dealing with the large north-south economic disparity on the Korean Peninsula. I do not need to advise Korea on how best to take advantage of OECD's work and their participation in the Organisation as it addresses these and other challenges. We have seen over the past day and a half that Korea fully understands how to do this, indeed Korea has become a model for other Members in this regard. Korea's membership over these past 5 years has been highly beneficial and this is only the beginning. Thank you for inviting me to participate in this important event.

CLOSING REMARKS

Kyung Tae Lee
President
Korea Institute for International Economic Policy

Distinguished Guests,
Ladies and Gentlemen,

I'm very pleased to report to you that the 2nd Korea-OECD conference in Seoul is successfully drawing to an end. The theme for the 2nd conference "Korea's Five Years in the OECD: Finding a New Path" has been very well chosen and proved to be of great importance indeed, as Korea prepares for the "New Leap" into the 21st century.

In the first session, we were able to learn, in detail, how the OECD contributed to the formation of Korea's economic policy. The OECD was instrumental in enabling Korea to overcome the economic crisis of 1997, and it has been our country's main advisor and supporter as we push ahead with our restructuring efforts.

I believe, all Koreans, including myself, were very encouraged by Dr. Jones's positive assessment of Korea's performance in macroeconomic and structural policies. I realize some Koreans are pessimistic about Korea's restructuring efforts and its future in general. Of course, Korea still faces tough challenges and needs to further improve its polices in the years ahead, but I believe Korea is doing well and will do even better in the future with the OECD-Korea partnership.

Improving the implementation of fiscal and monetary policies, furthering corporate and financial sector restructuring, strengthening the social safety net and labor market flexibility, and reforming the pension system to cope with an aging population -- these are all issues Korea takes very seriously in its move towards becoming a market-driven economy.

In the second session, the subject of structural adjustment and systemic risk, which is of critical importance to Korea, was discussed in depth.

Dr. Michaski focused on the corporate sector, Dr Atkinson on the financial sector, while Dr. Lee explained Korea's experience. As it was discussed, any government intervention needs to strike a balance between addressing the immediate systemic concerns, and encouraging future risky behavior by investors. Also the interventions should be market-friendly and transparent.

The role of human capital in terms of sustainable growth is a germane issue to all economies, and the OECD should become a leading arena for the development of national HRD strategies among member countries in the information age.

All in all, the last 5 years have been a productive period of learning and networking for Korea. I believe the next 5 years will be equally encouraging. Korea is firmly committed to the visions of OECD. As Dr. Witherell stated in his keynote speech the other day: democracy, market economy, and the protection of human rights.

Korea will do its best to meet the expectations of our friend-nations in the OECD. We look forward to an even stronger partnership in achieving the OECD visions.

Thank you for your attention. I hope all of you to enjoy your remaining days in Seoul and have a safe trip back home.

Bon Voyage!

KOREA

Korea Institute for
International Economic Policy

300-4 Yomgok-dong, Seocho-gu, Seoul 137-747 Korea
Tel. (822)3460-1114 Fax. (822)3460-1122
URL: http://www.kiep.go.kr

9 788932 230313 94320
ISBN 89-322-3031-5
89-322-3020-X(세트)

값 10,000원
Price USD 10