OECD WANTS MORE ON KOREA'S ECONOMIC LIBERALIZATION PLANS
- A Review of the OECD Survey of Korea

Korea will join the OECD (Organization of Economic Cooperation and Development) at the end of this year. Even though there are still unresolved issues between the OECD and the Korean Government about Korea's liberalization plan, it seems that most of the obstacles for Korea's entry into the OECD have been resolved.

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Korea is a step closer to joining the OECD after scrutiny by two committees of the organization on eligibility for membership. The Committee on International Investment and Multilateral Enterprises (CIME) and the Committee on Capital Movement and Invisible Transactions (CMIT) completed their joint two-day review of Korea's eligibility on July 5. The CIME and CMIT will submit the outcome of their review to the executive committee of OECD by September.

A month before the two committees' review, the OECD's Economic Development Review Committee (EDRC) submitted a report on the Korean economy. According to the report, varied restrictions on financing are said to have hindered the development of Korea's financial industry. To help attain continued economic growth, the Government needs to minimize its intervention and to liberalize the financial market, the report pointed out.

The report has no special binding force on Korea, but it has a strong influence over Korea's establishment of economic policies, due to the recent movement to affiliate with the OECD. Therefore, it is worthy to review the report and to examine the OECD's perspective on the Korean economy.

The report in general consists of 5 chapters: recent trends and prospects, financial opening and its policy implications, the state of public finances, structural reform in the product and labor markets, and the conclusion.

The first chapter deals with a historical economic analysis and the future prospects of Korea. The economic development of the Republic of Korea over the last three decades has been the most rapid and sustained in the world. The report says that the success has been based on outward-looking policies that encouraged companies to adapt to the opportunities of world market. It continues that economic development was backed by a rapid increase in the size and quality of the labor force, a tax structure that encouraged saving and investment and sound public finances.

Between 1993 and 1995, there has been a marked cyclical pickup in activity, with GDP growth averaging almost 9 percent a year. The strength of the economy was linked to restructuring efforts of the major companies, which led to a substantial increase in profitability and investment. A large part of the extra capacity thus created was used to boost exports, which benefited from buoyant demand in Asia and a gain in competitiveness resulting from the appreciation of the Japanese currency. The high level of activity also raised capacity utilization and reduced the unemployment rate to a historical low of 1.8 per cent during 1995. The report also predicts that annual economic growth should be 7 to 8 percent that would make the Korean economy larger than all but six of the OECD members by the turn of the century.

The second chapter focuses on the financial sector. The report states that financial liberalization will be essential to sustain growth. A high degree of government control in the past has left the financial sector underdeveloped. The business activities of the different types of financial institutions remain subject to certain controls, thereby segmenting financial transactions and limiting the growth of the foreign exchange market.

To enhance the competitiveness of domestic financial market, the Government embarked on a program of financial liberalization with the implementation of the Blueprint for Financial Reform in several stages beginning in 1993. By the end of 1995, one year ahead of schedule, interest rates had been freed on all loans and on most deposits. The deposit banks, however, are still subject to certain official controls on their asset portfolios and have to maintain a high level of non-remunerated reserves with the central bank. The requirement that banks lend a fixed proportion of their resources to the manufacturing sector has recently been abolished; however, there are still quotas on their minimum lending to small and medium-sized enterprises. In addition, the government still owns a number of large banks, which account for one-eighth of domestic lending.

The report persists that government intervention in the financial sector needs to be further reduced as the economy continues to develop. This implies that the "policy loans", as well as quotas for lending to small and medium-sized enterprises, should be phased out. In addition, there is a need to harmonize regulations across the various types of financial institutions.

It also notes that the liberalization process of the domestic market-oriented financial sectors in Korea is far slower than that of overseas market-oriented ones, and restrictions are still stricter against capital inflows than capital outflows and also against short-term capital inflows rather than long-term capital inflows. In December 1995, a new detailed, five-year program for the removal of controls on capital movements was introduced. This program represents a clear acceleration of the transition to an open capital market.

The move towards financial liberalization will pose a number of serious challenges that will have to be met to ensure macroeconomic stability during the transition period to an open capital market. There is, indeed, a risk that an inflow of foreign capital could raise inflation if the government continues with its past policy of keeping the exchange rate within close limits against the dollar. In such an event, foreign investors could lose confidence in the management of the economy and withdraw their capital. On the other hand, letting the currency float to minimize such a risk might lead to an overshooting of the won above its equilibrium level and, in turn, a wasteful temporary transfer of resources from the tradable to the non-tradable sector of the economy.

In order to avoid such problems, the report suggests that there is some merit in a phased liberalization of capital flows. This may help guard against the risk of an excessive nominal appreciation of the exchange rate, while also providing time for strengthening the domestic financial structureIt could also involve further deregulation of long-term capital inflows, while freeing the entry of short-term capital at a later stage when interest rate differentials have been reduced. Thus, foreign direct investment and portfolio investment in equities and bonds could be freed from control more quickly than envisaged in the current plan.

Because of the influx of foreign capital, it suggests that greater exchange rate flexibility would be appropriate. On the other hand, to limit upward pressure on the currency in the course of financial liberalization, it will be necessary to follow a balanced economic strategy that allows monetary policy and fiscal policy instruments to absorb some of the strain imposed by potential capital inflows. As far as monetary policy is concerned, it is doubtful whether it will be possible to continue with the current close targeting of the M2 money aggregate in the context of increasing financial liberalization. Even a wider aggregate, such as M3, may become unstable as financial institutions offer new products and foreign competition increases. Consequently, there may be some advantage in shifting the formulation of monetary policy towards an explicit medium-

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term inflation target. It would also imply maintaining sound fiscal policies.

In this sense, the third chapter deals with the fiscal policy-related subject of public finances. Public finances, which have been run prudently during the past 25 years, can also play a role in promoting stability during the transition to financial liberalization. The government budget has been in surplus over the past two years and the 1996 budget aims for a very small deficit. Overall, the general government sector had a surplus of $3\frac{1}{2}$ per cent of GDP in 1995.

Despite such a favorable public finance position, there is a need for maintaining a cautious fiscal stance over the coming few years. By putting further downward pressure on interest rates, this might reduce the extent of the exchange rate appreciation, following financial liberalization and, in turn, limit the deterioration of the current account position.

The fourth chapter deals with structural reform in the product and labour markets. The recent progress in opening financial markets has been accomplished by structural reforms in other areas. The Korean Fair Trade Commission has been enhanced and made independent, which should allow more vigorous enforcement of the Anti-Monopoly Act.

In the labor market, the number of industrial disputes has declined sharply from the late 1980s. Nevertheless, it is important to amend the laws related to labor unions in order to bring them into line with the needs of Korea's rapidly changing industrial society. At the same time, the authorities should ensure that there is sufficient flexibility in the labor market to accommodate the rapid pace of structural change. In this regard, the employment security policy that makes it difficult for declining industries to reduce their work force, in the face of labor shortages elsewhere in the economy could be replaced in order to speed the pace of adjustment and maintain, growth.

The report also mentions that further measures are needed to limit government intervention and guidance of resource allocation in the economy. A welcome recent measure has been the almost total elimination of the regulations that restricted firms' investment in a new business line, which so reduced the efficiency of resource allocation in Korea. In a related area, the policy of encouraging the large business groups to specialize in core industries may have been ineffective, thus weakening competition while strengthening government-business links. Rather than focus on the size and ownership of the large groups, the Korea Fair Trade Commission should preferably increase its efforts to prevent unfair trade practices on a case-by-case basis, focusing on abuses by Chaebols and market dominating firms.

The shift of industrial policy from measures aimed at promoting specific products and industries to incentives to increase R&D expenditures has been beneficial. The plans to raise R&D spending to 4 per cent of GDP by 2000 should help Korean firms to strengthen their competitiveness.

The report concludes that reforms in most areas should be accomplished by measures to strengthen competition and reduce government competition, which has become most costly with the development of the economy. It further remarks that given Korea's judicious past economic management and high future growth potential, its further integration in the community of industrial nations will provide mutual gains.

The Korean government has recently expressed confidence that enough progress has been made in recent negotiations for its application to be approved by the OECD's governing council in September, paving the way for membership by the end of this year. However, an official of one OECD government said that Korea was being too optimistic. The remaining disputes are opening the bond market to foreign investors, environmental standing (OECD wants lower the CO^2 level in most industrial areas), and agricultural trade. VIP

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