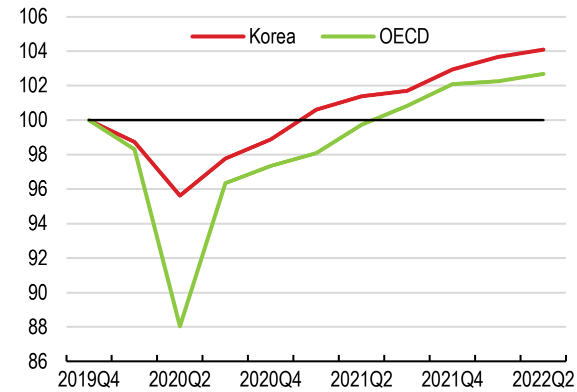
Executive summary

The economy is recovering

Korea's skilful management of the COVID-19 pandemic protected its people and economy. GDP per capita surpassed the OECD average for the first time in 2020 on the back of one of the smallest GDP contractions among OECD countries, followed by a strong export-led rebound in 2021 and early 2022 (Figure 1).

Figure 1. The economy has rebounded

Real GDP, 2019 Q4 = 100



Source: OECD Economic Outlook (database).

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The labour market is recovering. Employment has surpassed pre-crisis levels, led by health and public services jobs and job creation programmes. Manufacturing jobs have recovered to pre-crisis levels, while contact-intensive services lag behind.

Russia's invasion of Ukraine is weighing on economic activity and exposes supply chain dependencies. Korea's direct trade and financial links with Ukraine and Russia are limited, and stockpiles of oil and gas are considerable. However, a dependence on the two countries for raw materials to produce semiconductors highlights the need for resilience and diversification in the sourcing of key inputs for industry.

The recovery will continue, albeit at a slower pace. Real GDP is projected to grow by 2.8% in 2022, helped by additional fiscal stimulus from the Yoon government, and 2.2% in 2023. The Omicron wave and supply disruptions weighed on economic activity in early 2022, while the lifting of practically all restrictions set the stage for consumption in contact-intensive services to recover from late spring, although with a drag from inflation (Table 1).

Table 1. The recovery continues

(Annual growth rates, %, unless specified)

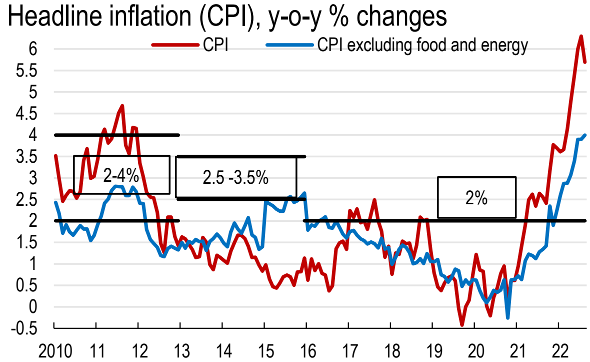
	2021	2022	2023
Gross domestic product	4.1	2.8	2.2
Private consumption	3.7	3.7	2.4
Government consumption	5.6	3.8	3.0
Gross fixed capital formation	2.8	-1.5	2.8
Exports	10.8	4.7	3.2
Imports	10.1	2.6	4.2
Unemployment rate (% of the labour force)	3.6	2.9	2.6
Consumer price index	2.5	5.2	3.9
Current account balance[1]	4.9	4.3	4.0
General government fiscal balance[1]	-0.8	-0.1	0.6
General government gross debt[1]	46.4	46.8	46.1

1. As a percentage of GDP.
Source: OECD Economic Outlook 111, projections revised as of 12 September 2022.

Monetary policy has been normalising on the back of high inflation pressures (Figure 2). Despite a tick-down, headline consumer price inflation remained almost triple the 2% inflation target in August 2022. Core inflation reached 4%. Wage increases remain modest. In a timely response, the Bank of Korea initiated normalisation in August 2021. So far, it has raised the key policy rate in seven steps from 0.5% to 2.5%, helping to keep inflation expectations anchored.

Figure 2. Inflation has risen fast

Headline inflation (CPI), y-o-y % changes



Note: In boxes, the medium-term consumer price inflation target.
Source: OECD Economic Outlook (database).

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Public debt remains low in international comparison despite large pandemic-related fiscal deficits. As consumption finds its new normal, continued pandemic support to businesses would hinder necessary structural change. Future ageing-related expenditure increases also call for a rebalancing of support going forward.

Emission targets require additional policy efforts

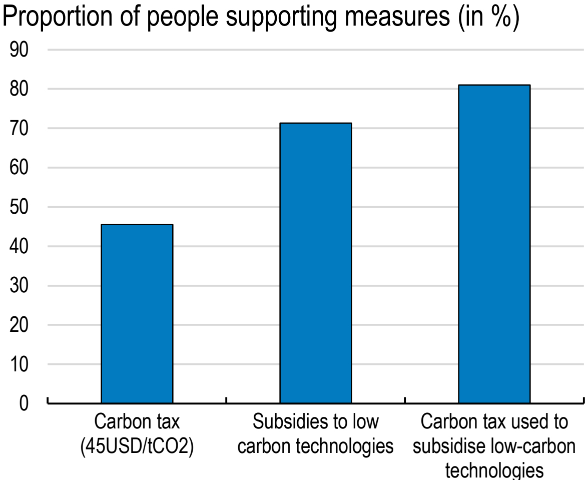
Korea is among the OECD's largest greenhouse gas emitters. It has committed to reducing emissions by 40% from the 2018 level by 2030, and to net zero by 2050. High emission intensity leaves room for emission reductions with considerable co-benefits from cleaner air. A renewed emphasis on nuclear will help, but investments need to be stepped up for renewables, transmission infrastructure and energy efficiency.

Korea's emission trading scheme (K-ETS), the first in East Asia, covers about three-quarters of domestic emissions, but is not yet aligned with the new and more ambitious emissions reduction targets. Improving the institutional framework for electricity supply would allow the marginal carbon cost to pass through, improving the effectiveness of the K-ETS for electricity generation, a major and systemically important emitting sector.

A large majority of Koreans support efficient climate policies, provided that an explicit price on carbon is combined with funding for low-carbon technologies and infrastructure (Figure 3).

Figure 3. Koreans support emission curbs

Proportion of people supporting measures (in %)



Source: Dechezleprêtre et al. (2022[1]).

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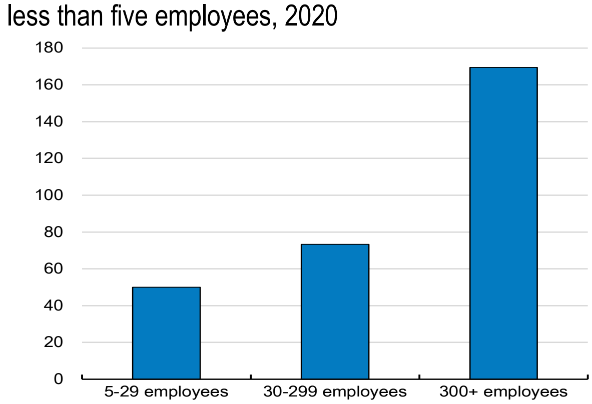
Productivity gaps trigger inequalities

Sizeable productivity gaps between large and small firms raise concerns about insufficient competition. Regulations are stringent, notably in services. Large companies are highly productive and have considerable economic power. Small and medium-sized enterprises (SMEs) with chronically low productivity receive numerous forms of support and special treatment allowing them to stay afloat. Compliance with worker rights to social insurance and minimum wages has room for improvement.

The productivity gaps lead to important income inequalities, which are compounded by labour market dualism. The incidence of non-regular workers is high in small companies relative to larger ones. Regular workers in large companies receive high wages (Figure 4), social insurance coverage and strong employment protection, while non-regular workers receive lower wages, are less likely to receive social insurance payments when they need it, and more likely to work in precarious jobs.

Figure 4. Large firms pay a premium

Per cent difference in wages compared to firms with less than five employees, 2020



Source: Statistics Korea.

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Women tend to end up on the wrong side of labour market dualism after childbirth, with a vastly negative impact on future earnings and social security. This stark choice between career and family largely stems from social norms and unforgiving work practices, but employer co-payments of maternal leave also play a role. The situation holds back female employment and leads young women to postpone family formation and have fewer children over their lifetime.

Youth struggle to end up on the winning side of social divides

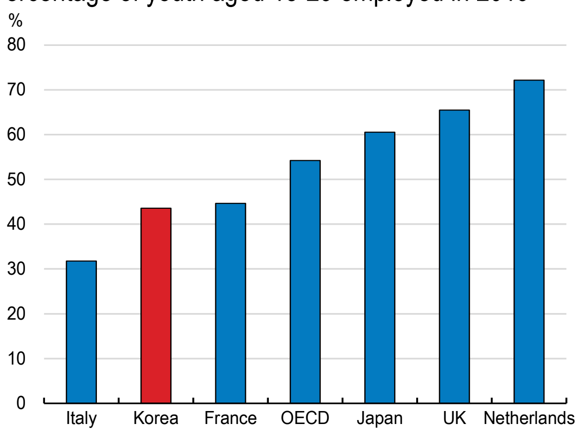
Faced with productivity gaps, labour market dualism and weaknesses in the education

system, young people compete fiercely to enter good universties and land secure and attractive careers in large firms and the public sector.

This Korean "golden ticket syndrome" leads to low youth employment (Figure 5) and family formation, reduces life satisfaction, and potentially has a long-term scarring effect.

Figure 5. Youth employment is low

Percentage of youth aged 15-29 employed in 2019



Source: OECD Labour Force Statistics (database).

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Competition to enter top universities is intense, leading to high pressure on students and large outlays on private tutoring. To gain admission, many students apply to departments that do not correspond to their interests and capabilities, resulting in sub-optimal use of talent. Universities face weak competition, in part due to admission quotas that are not flexible enough to respond to rapidly changing labour market demands.

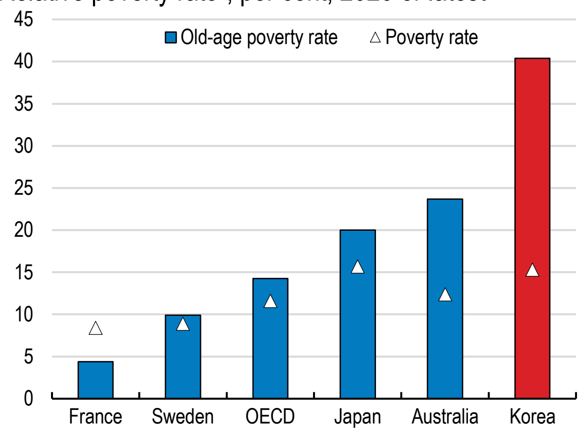
The decline in vocational secondary education has contributed to mismatch between youth's skills and labour market demand. The share of students attending vocational high schools fell from 40% in 1995 to 18% in 2021, reflecting in part a rise in vocational tertiary education. Moreover, their role has changed as the share of vocational graduates entering tertiary education has risen from 19% to 44%.

The social safety net is incomplete

Weaknesses in the social safety net contribute to persistently high income inequality and poverty, notably among the elderly (Figure 6).

Figure 6. Old-age poverty is high

Relative poverty rate[1], per cent, 2020 or latest



1. Individuals aged 66 and older. The poverty rate is the share of the number of people living with less than half of the median disposable income. Wealth, which increases consumption possibilities and is typically higher among older generations, is not reflected.

Note: OECD Income distribution (database).

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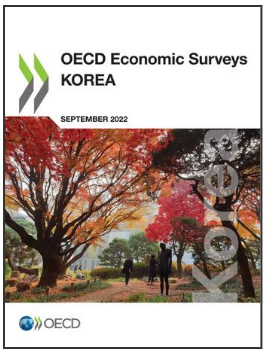
Only around half of the labour force has access to unemployment benefits. Furthermore, Korea's tax-benefit system may discourage taking up or returning to low-paid work from social assistance or unemployment benefits.

Korea's pension system as a whole fails to secure adequate pension income for many seniors. The Basic Pension is poorly targeted. Beneficiaries of the National Pension Service generally receive a low level of benefits, partly reflecting short contributory periods. Both workers and employers prefer severance payments over pension annuities, and participation in the supplementary personal pension scheme is low.

Despite mandatory insurance, health and long-term care is unaffordable for many elderly. Too few poor elderly are eligible for healthcare benefits under the Basic Livelihood Support. Many recipients of long-term care are unnecessarily hospitalised, reflecting weak primary care, lack of coordination between long-term care and health care, and underdeveloped home and community-based long-term care.

MAIN FINDINGS	KEY RECOMMENDATIONS
Supporting a resilient recovery	
Inflation is high and the robust recovery has shrunk economic slack, but uncertainties are high.	Gradually consolidate the fiscal position.
The Bank of Korea has raised its policy rate in steps to 2.50%.	Continue to move towards a less accommodative monetary policy stance with a view to keep inflation expectations in check.
Rapid ageing will exert increasing fiscal pressures. The government plans to propose a new fiscal rule that is more stringent than the proposal of the previous government.	Adopt the new fiscal rule and ensure the rule is followed.
Reaching greenhouse gas emission targets	
Korea's emission trading scheme (K-ETS) covers three-quarters of domestic emissions, but its emission cap is not yet aligned with recently strengthened emission reduction targets.	Align the emission trading scheme cap with domestic emission reduction targets and expand its coverage.
Improving the institutional framework for electricity supply would allow the marginal carbon cost to pass through, enhancing the effectiveness of the K-ETS for electricity generation, a major and systemically important emitting sector.	Comprehensively review the institutional framework hindering the carbon price from passing through and holding back emission reductions in the electricity sector.
90% of emission allowances are distributed to companies free of charge. 70% of Koreans support subsidies for low-carbon technologies and environmental infrastructure, while 80% support carbon pricing if revenues are used for such support.	Auction a larger share of allowances to K-ETS entities, and link auctioning revenue to subsidies for green technologies and infrastructure.
Reducing productivity gaps and labour market dualism	
The productivity gap between large and small firms is among the largest in the OECD, reflecting stringent product market regulation. Firms with at least 300 employees pay youth 50% higher wages than those with less than ten, and the gap widens with age.	Reduce the stringency of product market regulation by shifting to a comprehensive negative-list regulatory system, expanding the use of regulatory sandboxes and generalising reforms successfully trialled.
Over 40% of the employed 15-29 year-olds are non-regular workers. The low wages and low legal and effective social insurance coverage of such jobs prompt young people to queue for regular jobs rather than accept non-regular jobs.	Break down labour market dualism by relaxing employment protection for regular workers and making it more transparent, while expanding social insurance enrolment and training for non-regular workers.
Government support for SMEs is higher than the OECD average. To enhance the effectiveness of supporting policies, the government introduced a graduation scheme for technology credit guarantees in 2018 and for policy loans in 2019. It introduced an evaluation scheme, supported by the SMEs Integrated Management System (SIMS), in 2019.	Expand the coverage of SME graduation schemes to ensure that public support for SMEs encourages the growth of innovative firms rather than the survival of non-viable ones, while supporting affected workers and providing training and employment services.
Employers in general cover the first 60 days of maternal leave (with exceptions for SMEs), giving them an incentive to discourage leave.	Move towards greater public financing of maternal, paternal and parental leave.
Strengthening the social safety net	
Around half the workforce in Korea has access to an unemployment benefit through employment insurance, mainly due to the low participation of the self-employed. Childbirth-related benefits are also linked to employment insurance.	Include the self-employed in compulsory employment insurance, accompanied by more effective enforcement measures.
Elderly poverty is high. Korea's Basic Pension distributes limited resources very thinly to a large portion of the elderly. The government will set up a committee to review the pension system.	Pursue a broad pension reform to secure adequate old-age income. In this context, conditional on the reform of the National Pension Service, consider lowering the Basic Pension income threshold and increasing the benefit level to better target those with the highest needs.
Most pensions are below the poverty line, mainly due to short contributory histories and relatively low replacement rates. The maximum age for contributions is 60 years, while the pensionable age is 62.	Raise the pension eligibility age further than currently legislated by 2035 and link it to life expectancy thereafter, and align the maximum contribution age to the pensionable age.
Most employees choose lump-sum severance payments instead of the alternative corporate pension, contributing to the incidence of low retirement incomes.	Transition severance pay into individual pension accounts by capping and gradually reducing the amount available for early lump-sum withdrawals and limiting permitted causes.
Many recipients of long-term care (LTC) are unnecessarily hospitalised, reflecting financial incentives for both users and suppliers, lower quality of LTC institutions, and lack of coordination among LTC providers.	Harmonise long-term care insurance and healthcare insurance reimbursement schemes.
Promoting youth employment	
The priority on admission to top universities leads to intense pressure on students, large outlays on private tutoring and a low employment rate for tertiary graduates, while reducing interest in vocational education.	Allow students more scope to develop their individual interests and talents, notably by reducing the emphasis on the standardised university entrance exam.



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