April 2, 2020
Approval: 4/9/20

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/37-2

10:20 a.m., May 8, 2019

2. Republic of Korea—2019 Article IV Consultation

Documents: SM/19/89 and Correction 1; and Supplement 1; and Supplement 1, Correction 1; SM/19/90; and Correction 1

Staff: Feyzioglu, APD; Kaufman, SPR

Length: 1 hour, 27 minutes

Executive Board Attendance

T. Zhang, Acting Chair

Executive Directors	Alternate Executive Directors
D. Mahlinza (AE)	
	M. Alle (AF), Temporary
	C. Moreno (AG), Temporary
	N. Heo (AP)
A. Tombini (BR)	
Z. Jin (CC)	
	P. Moreno (CE)
L. Levonian (CO)	
R. Kaya (EC)	
	A. Castets (FF)
	K. Merk (GR)
S. Gokarn (IN)	
	Collura (IT)
Saito (JA)	
	K. Osei-Yeboah (MD), Temporary
	M. Merhi (MI), Temporary
	D. Cools (NE), Temporary
	J. Sigurgeirsson (NO)
A. Mozhin (RU)	
	R. Alkhareif (SA)
A. Mahasandana (ST)	
	P. Trabinski (SZ)
	O. Haydon (UK), Temporary
M. Rosen (US)	

H. Al-Atrash, Acting Secretary
O. Vongthieres, Summing Up Officer
A. Bala, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
Asia and Pacific Department: R. Craig, N. Feyzioglu, N. Hansen, K. Kang, D. Lee, S. Rafiq, C. Rhee, R. Xu. Finance Department: E. Zoli. Monetary and Capital Markets Department: Z. Arvai, K. Beaton, U. Das. Strategy, Policy, and Review Department: M. Kaufman, V. Klyuev, A. Swiston. World Bank Group: N. Von Der Goltz.

Executive Director: N. Ray (AP). Alternate Executive Director: L. Palei (RU), M. Siriwardana (IN). Senior Advisors to Executive Directors: M. Choueiri (MI), F. Fuentes (BR), G. Heim (SZ), W. Kuhles (GR), Y.Liu (CC), S. Potapov (RU), J. Shin (AP). Advisors to Executive Directors: O. Bayar (EC), M. Bernatavicius (NO), S. David (AP), J. Garang (AE), M. Kikiolo (AP), G. Kim (AP), U. Latu (ST), A. Park (AP), J. Montero (CE).

2. REPUBLIC OF KOREA—2019 ARTICLE IV CONSULTATION

Mr. Heo, Mr. Shin and Mr. Kim submitted the following statement:

On behalf of the Korean authorities, we would like to thank staff for the candid and constructive discussion and policy dialogue during the 2019 Article IV consultations. The authorities broadly agree with staff's assessment and policy recommendations. The Korean economy has strong economic fundamentals with a stable financial system, low public debt, and ample foreign exchange reserves. Amid the challenging global environment, Korea is facing cyclical headwinds with risks tilted to the downside.

Outlook and Risks

External uncertainties such as US-China trade tensions and a global slowdown in the tech cycle, especially for semi-conductors which account for about 21 percent (customs clearance basis in 2018) of Korea's exports, has dampened both exports and facility investment. Along these trends, compounded by base effects in government investment, growth in Q1 of 2019 unexpectedly dipped 0.3 percent (Q on Q). The temporary drop in government investment was mainly driven by slow budget execution in Q1 this year due to delays in bidding and contracting, compared to the large increase in government spending in Q4 of 2018[1] following last year's supplementary budget.

The Korean authorities still see this year's growth target of 2.6-2.7 percent as achievable. While private consumption remains solid, they expect a steady rise in export volumes from the second half of this year. Policy efforts are also being made to boost the economy including through expansionary fiscal spending and multi-pronged investment stimulus measures. Furthermore, they have committed to closely monitoring economic conditions and taking additional actions as necessary.

Fiscal Policy

Fiscal policy will remain expansionary in accordance with staff's recommendation. The increase in expenditure of 9.5 percent in the 2019 budget is at the highest level since the global financial crisis. Furthermore, the government has frontloaded spending, committing 61 percent of the budget in the first half of this year. To improve spending efficiency, budget execution is

---

[1] Government spending increased by 18 percent (Q on Q) in Q4 of 2018.

being thoroughly monitored and assessed to feed into the budget adjustment in the following year.

A supplementary budget bill of KRW 6.7 trillion or 0.4 percent of GDP was also submitted to the National Assembly last month. The size of this supplementary budget could seem smaller than those in past years, but if it is combined with grants already disbursed to local governments[2] in early April (10.5 trillion KRW), the additional fiscal support beyond the original budget would amount to around 0.9 percent of GDP. This extra budget will support measures to ensure public safety against fine dust pollution and disasters. It will also prevent downside risks from materializing in the early stages by propping up exports and investments, job creation and strengthening the social safety net.

The authorities are of the view that fiscal sustainability could be strengthened with additional revenue mobilization, mainly by broadening tax bases. On staff's suggestion to increase the neutrality of corporate income taxation to enhance resource allocation, the authorities take a cautious position, in that it should be reviewed across the whole tax system more holistically, taking country-specific circumstances into account.

Monetary Policy and Financial Sector

The authorities consider the current policy rate supportive and accommodative. The Bank of Korea (BOK) has conjectured that the output gap has been slightly negative. The difference between the output gaps estimated by the BOK and the IMF is attributable to the IMF's overestimation of potential GDP for 2010. The BOK plans to closely monitor any changes to financial and economic conditions at home and abroad and take a data-dependent approach in managing monetary policy.

Korea's financial system has performed well with the subsequent implementation of the Basel III framework and regular stress tests for the financial market. The BOK and the Financial Supervisory Services have implemented regular stress tests to monitor the loss-absorbing capacity of the financial system against potential risk factors given financial institutions' interconnectedness.

[2] According to National Finance Act, around 40 percent of excess domestic tax revenues are supposed to be distributed to the local government.

Efforts are being made to contain the rapid growth of household debt utilizing diverse macroprudential measures (MPMs). The BOK underscored that, while the MPMs are effective in specific markets, using a mix of the MPMs and monetary policy would be much more effective in addressing overall financial stability risks. Key policy goals include managing household debt growth, supporting vulnerable borrowers, and improving household loan structures from floating-rate interest-only to fixed-rate amortizing payment. The authorities intend to maintain household debt growth at around the rate of nominal GDP growth over the mid-to-longer term. On top of the loan-to-value and debt-to-income ratios, they have introduced the debt service ratio as a controlling indicator for the banking sector, and it is also expected to be applied to non-banking sectors in June 2019.

The authorities also remain vigilant to monitor property prices linked to the financial market. While overall housing market risks are currently being contained with tightened MPMs, the government will continue its policy efforts to maintain market stability—focusing on suppressing the speculative demand, supporting occupiers for purchasing their own house, and implementing targeted measures by region.

External Sector

The current account surplus is expected to decline gradually. The authorities note staff's assessment that Korea's external position in 2018 is moderately stronger than warranted by medium term fundamentals and desirable policy setting. They expect staff to keep refining the model and reflect country specific factors such as rapid population aging and potential reunification costs in assessing the external position. They also have concerns over staff's view on FX macroprudential measures. A levy on non-deposit foreign currency liabilities and a leverage cap on FX derivatives have helped prevent excessive build-up of short-term debt and lengthen the maturity structure of debt. These measures are not residence-based and were never intended to limit capital flows, rather to reduce systemic risks in the financial market. In this context, they clearly need to be classified as MPMs under the Fund's Institutional View.

From March this year, Korea has begun to disclose FX market intervention data to enhance the transparency of its foreign exchange policy. The data for the second half of last year were posted on the website of the

BOK in end-March this year and the BOK will keep up these postings going forward.[3]

Structural Policies

One of Korea's key policies is promoting innovation to boost productivity. The authorities implemented a law on a regulatory sandbox that is pre-permissive and post-regulatory. They expect to make many successful cases from the regulatory sandbox starting this year. The authorities have also focused on supporting finance, taxation, and regulatory changes in four major service sectors such as tourism; healthcare; smart-logistics; arts and entertainment contents (i.e. K-contents). In addition, R&D investment, particularly in driverless cars and artificial intelligence, has increased in preparation for the fourth industrial revolution. Tax benefits will also be given on private fifth-generation (5G) network investments. The Korean government launched a task force for innovative growth in April. Moreover, the authorities support the restructuring of insolvent companies promptly, with three major principles—holding large shareholders responsible, sharing the burden among stakeholders, and ensuring companies make tough decisions to survive on their own.

Korea continues to promote labor market stability and flexibility through social dialogue and compromise. The authorities support transforming irregular workers into regular ones, while strengthening the social safety net through measures such as unemployment benefits and further improving active labor market policies—including public employment services and vocational training—which is also emphasized in the selected issue paper. They encourage adopting a performance-based payment system over seniority-based salaries. In addition, they also concur with staff that 52 working-hours per week would be beneficial in terms of workers' well-being, productivity, female labor supply, and fertility.

The Korean government is putting in every effort to ensure the smooth implementation of the minimum wage policy. Since there is a relatively high portion of low-wage workers (receiving less than two-thirds of median income) in Korea, with comparably lower social expenditures, the minimum wage plays an important role in correcting inequality and boosting domestic consumption. In the meantime, the authorities are trying to cushion the adverse impact on production by providing temporary financial support to the

3 From July 2018 to June 2019, biannual data for net purchases of foreign assets will be revealed with a time lag of 3 months, and afterwards (from July 2019) quarterly data will be provided within 3 months.

self-employed and to SMEs that may experience difficulties from the minimum wage increase. A bill to introduce a new minimum wage setting mechanism with two sub-committees (i.e. the range-setting committee and the decision-making committee) is currently being discussed at the National Assembly. The former will consist of experts who will set the upper and lower bands of the minimum wage, based on objective indicators. The latter will make the final decision within the range, enhancing the objectivity and rationality of the minimum wage and encouraging wider social acceptance.

Expanding public sector jobs is necessary to provide quality public services in an aging society. The share of public employment in Korea is lower than half of the OECD average. The authorities plan to increase public employment particularly in understaffed areas like security and welfare, where the private sector cannot replace it easily.

Tackling low fertility and aging is one of the top policy priorities. The authorities have laid out a basic plan for addressing the low birth rate and aging society, which is renewed every five years. In February, the authorities released the third basic plan with a variety of policy measures. Coverage of maternity benefits and a subsidy for shortening working hours for childcare have been expanded. They plan to increase paid parental-leave days for spouses at the time of childbirth and establish more daycare centers in the workplace to further facilitate female labor force participation. In addition, a new governmental task force will investigate the impact of the demographic change on employment, budget, welfare, education, and industrial structure in order to enhance the adjustability of the economy and prepare comprehensive policy responses for the future.

Mr. Lopetegui and Ms. Moreno submitted the following statement:

We thank staff for the papers and Mr. Heo, Mr. Shin, and Mr. Kim for their informative buff statement. Against a background of sound economic performance and policies, Korean growth is slowing, due mainly to external factors including trade tensions and the slowdown in China. With inflation below target, signals that the output gap is negative, and a still comfortable current account surplus, we believe there is space for supportive monetary and fiscal policies, as recommended by staff. Over the medium term, Korea will face challenges posed by a slowdown of potential growth, arising from demographic factors but also from lower productivity growth. In addition, Korea needs to address increasing inequality, the duality in the labor market, and product markets reform, which could contribute to increasing productivity.

Even though the base scenario appears benign, external risks can hit the Korean economy, reducing growth and weakening the currency via capital outflows. On the domestic front, risks might arise from the housing sector, with lower prices, impacting household debt. The labor market duality and the way in which minimum wage is set, may also pose some risks to job creation. We note that the authorities have reservations regarding the staff's output gap assessment, as well as the external assessment.

We agree that the exchange rate should continue to move flexibly, with intervention only to address disorderly market conditions. Since the authorities are comfortable with this principle, we would welcome staff elaboration on how disorderly market conditions have been or are expected to be determined in Korea? We welcome progress towards continued publication of FX intervention.

While there is ample fiscal space and short-term fiscal policy could be expansionary in the current cyclical conditions, we wonder regarding the exact meaning of the staff's recommendation that "fiscal policy should maintain an expansionary stance over the medium-term" (paragraph 43). We note that on the one hand staff notes that aging will require higher revenue mobilization in the future and on the other, that the structural balance should be reduced towards zero in the coming years. Staff comments about how the different variables are expected to behave are welcome.

On revenue recommendations, we agree with staff that lower fiscal incentives to corporate debt-financing may be appropriate and that progressivity in the corporate income tax may lead to fragmentation of integrated businesses. Could staff comment on what is the rationale for having a progressive corporate income taxation in Korea?

The financial system appears to be sound and with adequate liquidity buffers, both for the banking and non-banking institutions. We praise the authorities for such an outcome as the latter are a growing source of concern in other financial markets.

Use of macroprudential policies -as opposed to monetary policy- to manage financial stability risks, as recommended by staff, appears appropriate. We acknowledge that the authorities have been at the forefront in effectively using macroprudential tools to moderate credit and house price cycles in the past.

We agree that labor and product market reform could increase competition and growth, in particular, with the proposal of adopting "flexicurity" as the basis for the labor market policies to boost employment and reduce labor market duality. Reducing the gender pay gap should be a priority -as it is one of the highest in the OECD-, as well as boosting youth employment.

In the medium term, and in addition to reducing regulatory burden, the authorities should consider further liberalization of foreign trade and investment.

With these comments we wish the Korean authorities the best on their future endeavors.

Ms. Levonian, Ms. McKiernan and Ms. Vasishtha submitted the following statement:

Following a period of strong growth performance, the Korean economy is facing cyclical and structural headwinds. The recent growth slowdown has been driven by slowing demand from China, disruptions from the U.S.-China trade dispute, and the global trade slowdown. Meanwhile, long-term growth is facing challenges from an aging population, slowing productivity growth, and rising income inequality, partly reflecting weak social protection, and labor and product market duality. Considering these challenges, a combination of macroeconomic, structural, and financial policies is needed to achieve balanced and sustainable growth, as noted in the comprehensive staff reports. We note that the authorities are appropriately focused on achieving stronger and more balanced growth as helpfully laid out in the buff statement by Messrs. Heo, Shin, and Kim.

While we commend the authorities for their commitment to fiscal prudence, fiscal policy could do more to contribute to domestic demand. The authorities have adopted an expansionary fiscal stance but are taking a more cautious approach than recommended by staff with a view of saving for future fiscal challenges presented by an aging population. We agree with staff that, with a debt-to-GDP ratio of under 40 percent, Korea has ample fiscal space to boost domestic demand. Additional spending should aim at strengthening social safety nets and promoting inclusive growth, while ensuring that fiscal stimulus is efficiently spent.

We agree with the staff's recommendation to ease monetary policy, given that inflation is projected to remain below target, inflationary pressures remain subdued, and the output gap is estimated to be negative. We note, however, that the authorities view the current monetary stance as being sufficiently expansionary. In our view, the extent of monetary easing should be driven by the need to appropriately balance current macroeconomic trends, financial stability risks, and the need to preserve policy space to address future possible shocks. Furthermore, the exchange rate should continue to move flexibly, with intervention limited to addressing disorderly market conditions. Like staff, we welcome the authorities' move to publish data on FX interventions.

Loan growth to household has slowed recently, but it continues to rise faster than incomes. Household debt-to-disposable income is above 160 percent, and more than two-thirds of that debt stock is held with a variable rate. Tighter macroprudential regulations have successfully curbed some of the riskier lending categories, reduced household debt growth, and moderated the rise in house prices. However, annual house price growth continues to increase sharply in certain geographic regions. Could staff share their views on the potential for additional demand-side and supply-side measures to complement macroprudential measures in addressing housing market issues?

We concur with staff that financial risks should be managed through macroprudential policies instead of monetary policy. The empirical evidence presented in the insightful Selected Issues paper on macroprudential policies suggests that monetary policy alone has been less effective in addressing financial risks during the inflation targeting period in Korea. Macroprudential policies have been effective in moderating credit cycles and house price cycles and should continue to be used as a first line of defense to contain systemic financial risks.

Structural reforms to mitigate duality in the labor and product markets, and to support job creation are necessary to raise productivity and foster inclusive growth. In the labor market, there is a significant divide between regular and non-regular workers, which contributes to inequality and sluggish productivity growth. We support staff's recommendations to pursue greater "flexicurity" reforms to allow greater flexibility for workers, strengthen the safety net for the unemployed, and dedicate more funds to Active Labour Force Policies. We are encouraged to see the authorities' planned efforts in this regard.

We share staff's concerns regarding the impact of the planned minimum wage increase on hiring of low-skilled workers, which could disproportionately hurt youth, elderly, and female employment. Do Staff have a view on the employment impact of the 2018 minimum wage increase?

Mr. Fanizza and Ms. Collura submitted the following statement:

We thank staff for their comprehensive and insightful set of papers - in particular the richness of the Select Issues Papers, and Mr. Heo, Mr. Shin, and Mr. Kim for their helpful buff statement. We broadly share the staff's appraisal and will offer the following comments for emphasis.

We appreciate the staff's efforts to identify more comprehensive ways to assess the extent of the output gap, and we concur with the conclusion that broader measurements of the labor market slack with discouraged workers may be most relevant. To which extent do staff determine that the dual nature of the Korean labor market might have an impact on this analysis? We note the staff's assessment that the incorporation of discouraged workers would lead to more volatile output gap; however, it seems that it could be less prone to overly optimistic assessments – at least after a period of crisis, e.g., in the years 2010-2011 the output gap based on the unemployment rate from negative goes up to slightly below 1 percent. We would encourage the staff to continue working on this methodology and assess robustness of findings in other economies.

While we appreciate the authorities' intentions to move toward an expansionary fiscal stance in 2019, we share the staff's view about the need of additional fiscal easing in 2019 and beyond. Should the broader measurement of labor market slack (i.e., plus discouraged workers) be considered, would the staff's advice change in terms of the extent of the needed fiscal stimulus in 2019 and in the medium-term? Korea should take advantage of its fiscal space to put in place a well-coordinated set of measures aiming at enhancing the social safety net, supporting the adoption of structural reforms, and reducing excessive imbalances.

Labor market and other structural reforms are necessary to boost employment and entrepreneurship, in particular among women, the young and the elderly. Like staff, we would be cautious about expanding public employment to create jobs. However, considering that public employment in Korea was the second lowest in the OECD at 8 percent of total employment in 2015, there is room for the authorities to decide whether certain services – in light of their social preferences, such as education or health, might be provided by the private or the public sector.

Concerning monetary policy, we believe that the authorities should prevent a further weakening in inflation expectations. We share the staff's view that macroprudential measures, rather than monetary policy, are better tailored to address financial risks. We are not sure about the staff's assessment on the leverage cap on banks' foreign exchange derivatives positions and the levy on foreign exchange funding in respect to the Institutional View on capital flows. We would appreciate if staff could elaborate more on this issue. Finally, we welcome the authorities' decision to publish data on FX interventions.

Mr. Merk and Ms. Kuhles submitted the following statement:

We thank staff for the informative set of reports and Mr. Heo, Mr. Shin and Mr. Kim for their helpful buff statement. Korea is subject to a difficult environment with external pressures from the global trade slowdown as well as domestic challenges emanating from inter alia labor market rigidities, ageing and elevated levels of household debt. Overall, sound fundamentals and prudent macroeconomic policies have alleviated the impact of these pressures so far, with growth moderating but not stalling. The main challenges ahead to gain momentum will be to further strengthen fundamentals and expediently tackle structural weaknesses that hamper productivity growth while preserving fiscal and monetary soundness and improving social outcomes.

We appreciate the overall sound state of the financial system, although household indebtedness remains a source of vulnerability, exacerbated by the potential risk of house price revaluations. We concur with staff's recommendation that macroprudential measures should remain tight to contain risks. In this context, we note the dissent between authorities and staff on the right balance between macroprudential policies and monetary policy in addressing financial stability risks. While this debate goes well beyond the scope of this report alone, we are generally supportive of staff's notion that the primary role of safeguarding financial stability falls on macroprudential policies. However, as monetary policy influences financial market participants' propensity to take risks, due attention should be given to effects on the stability of the financial system as a whole, in line with the Bank of Korea's monetary policy objectives.

On the monetary policy stance and risks to price stability, we are reluctant to sign up to staff's recommendation of further easing. While the outlook has slightly weakened, we tend to share the authorities' view that the current monetary policy stance provides for a sufficient degree of accommodation and that some policy space should be preserved at this stage. The authorities view inflation expectations as well anchored, whereas staff sees signs of a decline. Could staff give further details on its assessment of the trend of inflation expectations, also given that real interest rates would be accommodative even by staff's estimate of the neutral rate if one assumes well-anchored expectations (Box 2)?

We are sceptical of staff's call for a significantly more expansionary fiscal policy. Against the backdrop of significant downside risks related to trade conflicts, ageing and household indebtedness, we consider a more cautious approach of preserving fiscal buffers as warranted. Additionally, we have sympathy for the authorities' reservations with regard to staff's external sector assessment and take due account of the long-term fiscal challenges stemming from demographics and possible reunification costs, which also correspond with our own experience.

We share staff's view that diversifying the manufacturing sector and promoting service sector liberalization is crucial for strengthening long-term growth. The high sectorial concentration of the economy and dominance of a few large firms have increased the potential exposure of the economy to external as well as firm-level shocks. This underscores the importance of intensifying the diversification of the industrial base and creating a business environment that gives market participants the opportunity to enter, innovate and grow without undue barriers to competition or taxes that could disincentivize small and innovative firms. In a related manner, we welcome staff's recommendations for comprehensive product market reforms in the non-manufacturing sector.

We agree with staff that long-term labor supply should be expanded through a more effective activation of both young and female workers in particular. To this end, we encourage the authorities to explore group-specific policies that could enable and incentivize increased participation (e.g. training, child care provision and tax provisions).

Priority should be given to job creation in the private sector. Making labor markets more flexible while protecting workers through social safety nets and promoting skill-building through active labor market policies is a welcome approach in this regard. Expanding the size of the public sector's workforce, however, is unlikely to constitute a sustainable tool to fight unemployment, but should primarily be based on the needs of public service delivery, be within the constraints of fiscal affordability and avoid a crowding-out of the private sector.

Mr. Daïri and Mr. Osei Yeboah submitted the following statement:

We thank staff for the comprehensive set of papers and Mr. Heo, Mr. Shin, and Mr. Kim for the informative buff statement. We concur with the thrust of staff appraisal and offer the following comments for emphasis.

Korea's economic fundamentals continue to be strong, despite a recent slowing down of growth, mainly reflecting lower foreign demand, while domestic demand is boosted by fiscal stimulus. Inflation and inflations expectations are low and external buffers remain sizeable. That said, income inequality is high and worsening. Moreover, the persistent challenging global environment poses downside risk to the medium-term outlook, while domestic downside risks arise from slowing productivity growth, labor and product market duality, excessive household leverage, and unfavorable demographics. We agree with staff call for appropriate macro-fiscal and structural policy mix to raise productivity, reduce internal and external imbalances, and preserve financial sector stability and resilience.

Korea has sizeable structural fiscal surpluses, and debt-to-GDP ratio is contained at less than 40 percent. We find the 2019 expenditure-oriented fiscal stimulus appropriate. Moreover, with the output gap expected to remain negative, the authorities can adopt a more expansionary fiscal stance to boost growth and labor productivity while strengthening social safety nets. We agree with staff that through their impact on productivity and profitability, well-designed fiscal and structural policies can better protect employment gains than transfers to SMEs to protect jobs. Promoting investments in innovation will be pivotal for long term growth. Strengthening revenue mobilization is also crucial, given the upcoming population aging challenges. This will require in particular a broadening of the tax base and a reduction in tax expenditures. We also agree on the need for ensuring neutrality of corporate taxation of debt and equity.

We agree that a more accommodative monetary policy stance is appropriate as inflationary pressures are weak and below target and inflationary expectations have started to decline. In that regard, policy should support boosting domestic demand to close the output gap and nudge inflation close to target. Authorities' stance to continue with flexible exchange rate regime, with interventions limited to smoothing excessive volatility, is commendable.

The banking sector is well capitalized with sizeable liquidity buffers, and the quality of banks' assets is good, with very low NPLs. We note that banks' profitability lags regional peers and household leverage continues to be high. With Bank of Korea having a dual responsibility of price and financial stability, an appropriately tight macroprudential policy stance is needed to contain high indebtedness of households and strengthen financial system resilience. The upcoming financial sector assessment program (FSAP) mission will be helpful in providing more insight on the effectiveness of banking sector supervision and adequacy of prudential policies to mitigate risks. We also look forward to the joint assessment of financial action task force (FATF) and Asia Pacific Group on the adequacy of AML/CFT framework in combating money laundering and other illicit financial flows.

Korea has significant structural rigidities in the labor and product markets which require well sequenced reforms to enhance employment and boost growth. Staff suggest, and authorities agree that flexicurity, combining flexibility in employment protection of regular workers with stronger safety nets for the unemployed and effective active labor market policies, could provide a strong basis for labor market reforms to boost employment and address labor market duality. Female participation in the labor market is the lowest among advanced economies, and youth employment lags OECD average. Active labor market policies, such as early childhood education and care, are required to incentivize females, while work-study programs and internships will enhance employability of youth. Continued efforts aimed at product market diversification will help reduce concentration risks in the manufacturing sector, and in this regard, the authorities' ongoing efforts to promote fair competition between large firms and SMEs will reduce vulnerabilities and have substantial impact on inclusive growth, as would further progress in product markets deregulation.

We wish the authorities continued success.

Mr. Sigurgeirsson and Ms. Eliassen submitted the following statement:

We thank staff for their thorough and well-targeted reports, and Mr. Heo, Mr. Shin, and Mr. Kim for their informative buff statement. Korea's economy is facing cyclical and structural headwinds. Global trade tensions and tepid domestic conditions contribute to slowing growth in the short term. At the same time, potential growth indicates decline on the back of adverse demographics and dwindling productivity growth. We broadly concur with staff's assessment and appraisal and offer the following remarks for emphasis.

We welcome the Korean authorities' commitment to implement the necessary fiscal measures to achieve their 2019 growth target. We would like to underline the importance of a fiscal stance and budget composition going forward that should aim to underpin long-term and inclusive growth.

Global trade tensions and growth slowdown in China create a challenging short- and medium-term economic environment. We agree with staff that continued efforts to diversify export markets and the manufacturing base through structural policies should help to mitigate these trends.

The long-term growth potential is held back by an ageing society and slowing productivity growth. At the same time, income inequality increases point to inadequate social protection and labor- and product market duality. We commend the Korean authorities on their work to consider these challenges and strengthen the social safety net. We encourage continued efforts to reduce both old-age poverty and in-work poverty in a manner that does not adversely affect employment. In this regard, we welcome the ongoing discussions on a new minimum wage determination mechanism.

Increased female labor force participation will be an important factor for continued economic growth. Staff's calculations indicate that the contribution of Korean women to growth has slightly exceeded that of men in the last decade. However, the Korean female labor market participation rate is still one of the lowest amongst advanced economies, leaving ample room for improvement. We commend the Korean authorities on their efforts to include more women in the labor market and welcome the supplementary information on these efforts given in the buff statement. We agree that new regulation on maximum working hours will be beneficial for female labor supply. This measure also has the potential to increase the work-life balance and well-being of all Korean workers, and to increase productivity and fertility.

Deregulating the non-manufacturing sector would also be an important lever to help boost long-term growth. Barriers to international trade and foreign investment are relatively high in Korea, and we strongly support staff's view that action be taken to enhance foreign competition through reducing tariffs and domestic co-financing requirements for foreign investments.

We note that there is a discrepancy between staff's and the authorities' views on the monetary policy stance. Monetary policy must be designed in an adequate manner and pursued consistently, considering the weak price pressures and the need to anchor inflation expectations. In our opinion, monetary policy should not be a main vehicle for managing financial risks. A flexible exchange rate should be maintained to help mitigate the adverse macroeconomic and market effects of global tensions and weak external demand.

Mr. Tombini and Mr. Fuentes submitted the following statement:

We thank staff for the reports and Messrs. Heo, Shin and Kim for their helpful statement. The Korean economy continues to lose momentum amid high trade uncertainties. Real GDP has contracted in the first quarter of 2019 (compared to previous quarter), driven by a sharp decline in exports and capital investment. In response to the weak outlook, the authorities have adequately adopted a balanced package of policy measures and reforms, supported by solid macroeconomic fundamentals and a strong policy framework. Yet, the current cyclical conditions may call for a more assertive use of available policy space to stimulate economic activity and build the consensus necessary in favor of well-tailored reforms to address medium-term challenges.

Trade uncertainty and tepid external demand are hindering exports and delaying investment decisions. Weakening demand for semi-conductors and moderating growth in China continued to impact Korea’s trade-dependent economy, with medium-term implications for growth prospects as business investment has declined. More generally, the economy remains highly exposed to the ongoing trade tensions between China and the U.S. due to its high degree of openness and integration into global value chains, prompting the need to seek further export diversification. Despite the challenging external circumstances, the external position remains strong, buttressed by a robust current account surplus.

The planned fiscal stimulus is an appropriate response to decelerating growth. The 2019 budget and the proposed supplementary fiscal plan are expected to bolster economic activity by substantially increasing public expenditure. Moreover, the review of existing regulations can give private investment a boost and benefit competition and innovation. Considering the weak external environment, additional fiscal easing may be needed beyond this year. Similarly, while monetary policy conditions remain accommodative, the Bank of Korea (BoK) may have room to further easing the policy rate given subdued inflation pressures.

Financial sector risks appear contained despite growth in household debt. The timely implementation of macroprudential measures have slowed down growth in household credit and housing prices, and have prevented the build-up of financial stability risks. That said, we agree with staff that the high level of household debt remains an important source of vulnerability that presents a difficult trade-off to the BoK between macroprudential measures and the use of the interest rate as a monetary policy tool. We appreciate the Selected Issues paper on the Evolution of Macroprudential Policies in Korea and the exercise suggesting that targeted macroprudential instruments may have been more effective in containing financial risks than monetary policy. Against this backdrop, we encourage the authorities to continue refining the focus of macroprudential policies to avoid unintended consequences on investment and growth.

Active labor market policies and reforms should remain a priority. Labor market dynamics and job creation are reflecting the slowdown in economic activity, as well as the impact of entrenched structural rigidities. Duality in the labor market persists, with a significant divide between regular and non-regular workers, sectors, and company sizes, constraining productivity growth and raising inequality concerns. Nonetheless, we welcome the authorities' commitment to labor market reform and to foster "flexicurity" in the labor market, including implementing the new regulation on maximum working hours, which could contribute to elevate employment and productivity.

Mr. Moreno and Mr. Montero submitted the following statement:

We thank staff for its comprehensive and insightful set of reports and Messrs. Heo, Shin and Kim for their informative buff statement. We mostly share the thrust of the staff's appraisal, but would like to offer some comments and qualifications.

The Korean economy has strong fundamentals, despite some cyclical and structural headwinds lying down the road. Economic activity is expected to moderate in 2019, reflecting weaker external demand and investment, but growth rates will remain close to potential and inflation at moderate levels. At the same time, the economy is displaying ample fiscal space, a large current account surplus and a sound financial sector—despite elevated household indebtedness—thanks to the many and varied macroprudential measures implemented over the last few years, as shown in Box 3, that have been effective in moderating credit and house price cycles. Even average indicators of financial soundness for non-bank financial institutions are also strong.

Indeed, the authorities continue to proactively calibrate the existing macroprudential measures and are also introducing some additional innovative ones, such as household-based counter-cyclical capital buffers, corporate LTD ratios and capital surcharges for life insurance companies. Certainly, the Korean authorities deserve praise for these macroeconomic achievements and are in an enviable situation to undertake bolder longer-term economic reforms that contribute to boosting productivity growth and to reducing excess external imbalances.

In this sense, we believe that the reform focus should be on more forceful actions to address the various microeconomic distortions affecting resource allocation in Korea, which are preventing a boost to potential growth and a more inclusive and sustainable growth model. To this end, we support staff´s proposals to use fiscal policy more proactively to improve social inclusion and to cushion the potential negative impact from some of the needed structural reforms (more on this below).

From a shorter-term point of view, most of staff´s assessment of monetary and fiscal policy stance hinges on the existence of slack, as measured by the output gap, or on estimates of the neutral real interest rate. As staff recognizes, the estimated slack is subject to substantial uncertainty, while the real policy rate is very close to the neutral one. The Korean situation is a case in point where it becomes evident that we urgently need an enhanced integrated policy framework to make better policy recommendations, especially in situations where there is so much uncertainty regarding the degree of slack and, despite highly loose financial conditions, inflation remains subdued. We believe that we need a particularly more innovative approach in the area of monetary policy, and start thinking about including non-conventional measures in the orthodox monetary toolbox. Has staff considered the adequacy of some unconventional monetary policy measures for the Korean case?

Relatedly, on macroprudential policies, the authorities have been deploying a comprehensive set of measures over the last few years. Consequently, we welcome that the forthcoming FSAP mission will focus on evaluating the effectiveness of current prudential policies for mitigating systemic risks. One of the purposes of these policies is to build enough financial buffers to absorb shocks. Does staff believe that the buffers accumulated by Korean financial institutions are ample enough to withstand severe shocks?

Korea's female labor force participation is one of the lowest in advanced economies—20 percent points below the best performers—while the gender pay gap is one of the highest in the OECD and the take-up of management positions is well below the OECD average. As staff rightly notes (and illustrates in Box 4), bridging the gap with male's participation rates would have substantial effects on output growth, in spite of the expected significant decline in working age population. In this context, efforts to encourage the participation and leadership of women in the labor market should be a priority. To this end, we share staff's proposals related to early childhood education and care, improved parental leave, and promotion of flexible-working agreements. We take positive note, in this regard, of the reduction in maximum weekly working hours, from 68 to 52, enacted in 2018, which will surely contribute to female labor market participation. We also welcome the release in February of the third basic plan to tackle low fertility and ageing, which consists of a variety of policy measures, and hope for its swift implementation.

Staff presents incomplete evidence on the impact of the increase in the minimum wage. Staff finds some evidence that the 16.4 percent increase of the minimum wage in 2018 (with an additional 10.9 percent expected for 2019) may have hurt employment of low-skilled labor, including the effect of the government's Job Stabilization Fund to subsidize SME's jobs. With this evidence, it might be too soon to extract conclusions and, furthermore to have a complete picture it would be desirable to assess the impact of this rise in the minimum wage on indicators of inequality, in-work poverty, etc. Notwithstanding the difficulties of this type of assessment, has staff attempted to estimate any of these effects? We take note that a bill has been submitted to Parliament aimed at improving the minimum wage setting framework. Could staff provide some details and preliminary assessment on the main measures considered? How will the sub-committee of experts set the upper and lower bands of the minimum wage?

Product market regulations are more restrictive relative to other OECD economies, notably, barriers to external competition. While the authorities have made some efforts to promote fair competition, such as the initiative to create regulatory sandboxes for selected sectors, significant barriers remain. Especially relevant are explicit barriers to trade and foreign investment, which act to shut domestic firms off from external competition, thus having deleterious effects on consumer welfare, productivity growth and corporate restructuring through distortions of the resource reallocation process. Therefore, we strongly support staff's view on the need to ease the regulatory burden, lower barriers to entry and promote foreign trade and investment liberalization. Given ample fiscal space, the authorities have the means to ease reallocation costs through fiscal policy by strengthening social safety nets and workers' re-skilling. Finally, we note that climate change-related issues are not addressed in this Art. IV. Although probably not macro-critical at this stage, this topic will gain prominence going forward, and it will be important to monitor the transition to a low-carbon economy. Could staff provide a brief assessment of the progress made towards achieving the goals set forth in the Paris Agreement?

Mr. Mouminah, Mr. Alkhareif and Mr. Keshava submitted the following statement:

We thank staff for the well-written set of reports and Mr. Heo, Mr. Shin, and Mr. Kim for their informative buff statement. We broadly concur with the thrust of the staff appraisal and would like to confine our remarks to a few points.

We welcome the strong fundamentals of the Korean economy and agree with staff on the need for an integrated package of policies to address a slowdown in growth as well as to tackle the structural challenges facing the economy while containing risks. This is important as growth is projected to further moderate in 2019 while inflation remains low. We also note that potential growth is declining, rigidities in labor and product markets continue, and social protection needs to be strengthened. In this context, while we are encouraged that the authorities are focused on supporting income, creating jobs, and promoting innovation, sustained efforts will be important.

The authorities are appropriately pursuing an expansionary fiscal policy over the medium term with a focus on enhancing social protection and labor productivity. Given the substantial fiscal space and the need to further enhance social safety nets, boost long-term growth, and support structural reforms, we see merit in staff's recommendation on pursuing additional fiscal easing in 2019 and beyond. Here, we take comfort in staff's assessment that aiming for a zero-structural balance in the medium term would not pose a risk to debt sustainability. On support to SMEs, we note the large number of fiscal programs and see benefit in periodically reviewing them to make them more efficient. In the longer term, the potential fiscal challenges from the aging population would necessitate greater revenue mobilization mainly by broadening the tax base.

On monetary policy, we note the difference in views between staff and the Bank of Korea on the need for easing and we would urge close monitoring to prevent a further weakening in inflation expectations. Here, we see merit in staff's view that macroprudential policies, rather than monetary policy, should be used to manage financial risks since well-targeted macroprudential policies would have fewer unintended consequences for other sectors of the economy. Since the rising household debt is the main financial risk, the authorities should maintain tight macroprudential policies to safeguard financial stability.

Finally, we encourage the authorities to press ahead with their structural reform agenda to foster innovation and productivity growth, support job creation and long-term growth, and strengthen social protection. In this connection, staff has made a strong case for more flexibility for regular workers, a strong and inclusive safety net for the unemployed, and effective active labor market policies. We also echo staff recommendation on the need for continued efforts to encourage the participation of women and boost youth employment. Easing the regulatory burden for firms would promote diversification and support long-term growth and we welcome the shared view between staff and the authorities on this matter. We are also encouraged by the authorities' emphasis on boosting innovation in start-ups.

With these remarks, we wish the authorities all the success.

Mr. Mozhin and Mr. Potapov submitted the following statement:

We thank staff for their insightful report supported by the well-focused SIP chapters and Mr. Heo, Mr. Shin, and Mr. Kim for their informative buff statement. Korea is facing both cyclical and structural challenges that are compounded by rising external risks. The growth rate of the Korean economy declined last year due to weaker exports and investment. The decline in the projections of potential output suggests the need for further diversifying the sources of growth. The authorities are addressing structural challenges associated with rapidly aging population, worsening income inequality, and slowing productivity.

According to the recent data for the first quarter of 2019, real GDP decreased by 0.3 percent compared to the previous quarter. The Consensus Forecasts for growth in 2019-20 deteriorated to around 2.4 percent. Could staff elaborate on the key drivers of the recent growth slowdown? Against this background, do staff see a need to revise their growth outlook or to put more emphasis on the downside risks?

Strong fiscal fundamentals provide the authorities with policy space to promote stronger and more inclusive growth. The 2019 budget envisages an increase in spending by 9.5 percent with the emphasis on social protection and job creation in response to weaker domestic demand. In addition, the authorities aim to boost public employment and adopt a supplementary budget of 0.4 percent of GDP. At the same time, we note that staff advocate an even greater role of fiscal policy in demand management in Korea by reducing the structural balance as a share of GDP by at least 1 percentage point in the short run. We agree that more counter-cyclical fiscal policy measures to support aggregate demand could be considered, taking into account the track record of prudent fiscal policy and relatively low public debt.

Fiscal challenges from the aging population will require greater revenue mobilization over the longer term. Outlays for pensions and healthcare are expected to rise by 10-16 percent of GDP by 2060. Given the low tax burden in the economy, there is ample space to choose growth-friendly fiscal reforms. We agree with staff that addressing distortions in corporate income taxation, improving the effectiveness of tax expenditures, and broadening the VAT base could provide significant revenue gains. At the same time, any future tax reform should address the growing need for social protection, while preserving proper growth incentives. The recent set of policy initiatives is rightly focused on supporting income, creating jobs, and promoting innovation.

Staff call for additional easing of monetary policy to ensure growth recovery, address falling inflation expectations, and facilitate faster convergence to inflation target. Under the baseline scenario, core inflation is expected to remain below the central bank target, in line with the negative output gap. Staff's analysis indicates that the neutral real interest rate has reached the levels close to zero, reflecting a combination of factors, including global trends, weak productivity growth, and the aging population. While we recognize the challenges of making such estimates, we see merit in staff's recommendation for additional monetary easing and are encouraged by the BOK's plans to closely monitor financial developments and economic conditions. The authorities' concerns regarding financial stability risks could probably be addressed by harmonizing prudential framework and maintaining the tight macroprudential policy mix. At the same time, we note that the effectiveness of macroprudential measures remains to be tested in the situations of stress.

On the external sector, we note that the current account surplus narrowed down from the peak of 7.6 percent of GDP in 2015 to 4.7 percent of GDP in 2018. Despite this substantial change, staff assessed the external position "to be moderately stronger than warranted by medium-term fundamentals and desirable policies". In our view, high uncertainty of the estimates requires caution in interpreting the outcomes of model-based assessments, while country-specific factors should be carefully considered. It is, indeed, challenging to draw a conclusion on the external position for the economy with substantial demographic challenges and potential reunification costs, since these specific factors are not fully captured by the EBA models. Moreover, Korea's NIIP in the amount of 25 percent of GDP appears to be a necessary buffer against the growing size and volatility of cross-border capital flows, as well as the uncertain future of the international trade rules.

We welcome the authorities' strategy to support income and address inequality concerns by increasing the minimum wage. At the same time, the impact of this strategy on employment and labor productivity should be closely monitored. While the provision of temporary financial support to the self-employed and to SMEs is intended to dampen potential negative implications, we agree with staff that these compensatory subsidies should be gradually phased out. In this context, we welcome the authorities' efforts to gradually introduce a new minimum wage setting mechanism.

Raising labor productivity is increasingly important for growth as working age share of the population peaked at 70 percent in 2016 and is expected to drop to 50 percent by 2050. We are encouraged by the authorities' reform agenda. Addressing labor and product markets rigidities, promoting innovation and job creation, enhancing female workforce participation, supporting SME development, and enhancing services sector productivity are important priorities for Korea to unlock new growth drivers and foster inclusion. Could staff elaborate on the authorities' plans to expand public employment as a way to address challenges related to the aging population?

With these remarks, we wish the Korean authorities success.

Mr. Ronicle and Mr. Haydon submitted the following statement:

We thank staff for their report and Mr. Heo, Mr. Shin and Mr. Kim for their informative buff statement.

As Mr. Heo, Mr. Shin and Mr. Kim rightly highlight, the Korean economy has strong economic fundamentals with a stable financial system, low public debt, and ample foreign exchange reserves. At the same time, it is facing cyclical headwinds, with growth expected to decline in the short term, reflecting slowing external demand. Korea also faces structural challenges common to many advanced economies, including adverse demographics, slowing productivity growth and an increase in income inequality. We therefore broadly agree with staff's assessment and policy recommendations, especially those that support the authorities' commitment to fostering growth through innovation.

We focus our comments on the following points:

Tensions in BOK mandate. In the absence of significant financial vulnerabilities, and with inflation below target and a negative output gap, we agree with staff that it would be appropriate to loosen monetary policy. Macroprudential policy could then be used if needed to manage any emerging financial vulnerabilities. Bank of England research has found that the macroprudential measures staff propose have the additional benefit of helping to insulate against spillovers from foreign shocks. Have staff applied the Fund's GDP-at-risk framework in reaching their judgment on the extent of financial vulnerabilities, and therefore the trade-offs faced by the BOK?

Structural factors in capital flows. Staff indicate that there is an investor base dimension to the stability of capital flows to the bond and equity markets. This speaks to an issue we consider important and under-weighted in Fund surveillance: the role of structural factors, including market-structural ones, in amplifying and mitigating capital flows at risk. We hope that the Integrated Policy Framework will lead to these structural factors being taken into account on more regular basis in future Fund surveillance of capital flows.

Alternative measures that do not limit capital flows. The report highlights how Korea has a leverage cap on banks' foreign exchange derivatives positions and a levy on foreign currency funding. The authorities assert that these measures prevent an excessive build-up of short-term external and FX liabilities. Staff argue that alternative measures should be considered, that directly address the systemic risks but are not designed to limit capital flows. We agree that such alternative measures should be used where available. Are staff able to elaborate further on what measures they consider appropriate?

Fostering growth through innovation. We welcome staff's recommendation that service sector liberalization should be expedited, including through the easing of regulatory burden for firms and by enhancing foreign competition through further trade and investment liberalization. Staff are right to highlight how product market regulations are more restrictive relative to most other OECD economies, even though Korea has undertaken substantial product market deregulation in the past. We welcome the authorities' initiative to create regulatory sandboxes, drawing on a pioneering model from the UK's Financial Conduct Authority.

Mr. Saito and Mr. Naruse submitted the following statement:

We thank staff for the informative reports and Mr. Heo, Mr. Shin, and Mr. Kim for their insightful statement. It is encouraging that Korea's economy has strong fundamentals but is facing cyclical headwinds to growth, such as China's growth slowdown and the weaker global trade, especially in semi-conductors. Also, Korea faces long-term challenges, such as adverse demographics and income inequality, and household debt. In this regard, we welcome the authorities' ongoing efforts to support income, create jobs, and promote innovation. As we broadly concur with the thrust of the staff's appraisal, we will limit our comments to the following points:

Fiscal Policy

In the short term, we support the staff's view that a more expansionary fiscal stance is needed to boost growth and inflation and reduce excess external imbalances. In this context, we welcome that the 2019 budget envisages an increase in government spending and the expenditure increase this year would be the highest since 2000. According to the staff's report, since 2016, revenue outturns have been significantly higher than envisaged in the budget and that the authorities did not expect significant revenue over-performance in 2019 as stronger-than-expected corporate income would be unlikely this year. Could staff elaborate the reasons on revenue outturns since 2016? And how do staff assess the authorities' view on the revenue performance in 2019? In addition, we positively note the authorities' commitment to take the necessary measures to achieve their growth target, including introducing a substantial supplementary budget to boost job creation, further enhance social safety nets, and address fine dust pollution. We agree with the staff's and authorities' view that fiscal stimulus should be efficiently spent and aimed at enhancing potential growth.

In the medium term, we note the staff's recommendation that fiscal policy should maintain an expansionary stance over the medium term to support inclusive growth and reduce excessive external imbalances. Also, we agree with the staff's and authorities' view that medium-term fiscal expansions should focus on enhancing social protection and labor productivity. In this respect, it is welcoming that the 2018-22 National Fiscal Management plan envisages a 10.3 percent annual increase in welfare, health and employment spending.

In the long term, we take note of the staff's assessment that old-age poverty is significantly higher than in the rest of the OECD and that outlays for pensions and healthcare are set to rise by 10-16 percent of GDP by 2060. In this vein, we agree with the staff's appraisal that fiscal challenges from the aging population will require greater revenue mobilization, given that Korea's tax revenue-to-GDP ratio is one of the lowest in the OECD. To this end, we support the authorities' intention to streamline existing tax reductions and exemptions to avoid distortions in corporate resource allocations.

Financial Sector Policy

While it is welcoming that risks to financial stability appear well contained, we encourage the authorities to continue addressing financial vulnerability, especially from household debt growth. We are pleased to see that the banking sector appears to be well capitalized with sizable liquidity buffers in place. However, staff describe that Korean banks' profitability lag that of regional peers. Also, we note with concern the staff's assessment that risks from household debt remain, although loan growth to households is slowing. In this regard, we positively note that the authorities have taken measures, such as the introduction of higher property taxes and the tightening of the loan-to-value and debt-to-income ratios, to addressing financial stability risks and strengthening the resilience of the financial system. Going forward, we agree with the staff's recommendation that macroprudential policies should remain tight to contain risks from household debt and sustain the financial sector resilience, while the authorities should closely monitor and supervise potential leakages from the tightening of policies.

Monetary Policy

We believe that monetary policy should remain accommodative to support demand and inflation. While the BOK emphasizes that cutting the policy rate would further reduce policy space to address possible future severe negative shocks, we are concerned that inflation is projected to stay below the BOK's target and there are signs that inflation expectations have started to decline. We tend to think that the cost of not easing monetary policy might be more than the benefit of maintaining policy space. On the other hand, the BOK views inflation expectations as well anchored. Could staff elaborate more on how much inflation expectations would be weakened and how serious this would be?

External Sector Issue

We agree with the staff's view that the exchange rate should continue to move flexibly, with intervention limited to addressing disorderly market conditions. It is encouraging that the authorities stressed that they adhere to the principle that the exchange rate is determined by the market. We also welcome the authorities' clarification that intervention policy in foreign exchange market was limited to episodes of disorderly market conditions. Moreover, we welcome the publication of data on FX intervention.

We note the divergence of views between staff and the authorities about the external sector assessment. We note that the current account (CA) surplus narrowed from 5.1 percent of GDP in 2017 to 4.7 percent of GDP in 2018. While the staff's external sector assessment shows that significantly more expansionary fiscal policy to boost domestic demand in the short and longer run will help to reduce imbalances, the authorities indicate that the IMF model did not consider some Korea-specific factors, including the need to save more in view of future challenges arising from demographic change and possible reunification. We would welcome the staff's response.

Structural Reform

We encourage the authorities to advance labor market reforms to mitigate duality and support job creation. We agree with the importance of more flexibility for regular workers, a strong and inclusive safety net for the unemployed, and active labor market policies. We support the authorities' continuous efforts to encourage the participation and leadership of women in the labor market. We are concerned about low fertility rate. In this regard, we welcome the authorities' various measures to tackle this issue, such as expanding the coverage of maternity benefits and a subsidy for shortening working hours for childcare. While high educational costs are often pointed out as a background of low fertility rate in Korea, how do staff assess the effectiveness of the authorities' measures to tackle low fertility rate? We believe that the authorities' measures, such as vocational schools, could help boost youth employment. Also, we agree with the staff's view that public sector job creation should be linked to developing services that cannot be provided by the private sector. Last but not least, regarding the minimum wage, we note that the hike for 2018 and 2019 are significantly larger than the expected labor productivity increase. We expect that the new minimum wage setting framework will better reflect economic conditions.

We encourage the authorities to ease the regulatory burden for firms to promote diversification and support long-term growth. We agree with the importance of reducing barriers to entry and the protection of incumbents in the product market. We believe that foreign competition could be enhanced by further trade and investment liberalization. In addition, we support the authorities' efforts to boost innovation in start-ups.

Mr. Doornbosch and Mr. Cools submitted the following statement:

We thank staff for the comprehensive set of papers and Messrs. Heo, Shin and Kim for their informative buff statement. We agree with staff's assessment that the Korean economy has strong fundamentals but is facing cyclical and structural headwinds amidst a challenging environment.

In short: we have questions about the extent of the fiscal stimulus recommended by staff; we request staff to further refine its external sector methodology; we encourage the authorities to intensify their efforts to increase labor market participation of women and youngsters; and finally, we commend the authorities for their extensive use of the macroprudential toolkit to stem financial sector risks.

First, we remain to be convinced of staff's recommendation for a further fiscal expansion beyond the authorities' plans. Downside risks stemming from household debt, geopolitical developments and societal ageing warrant a prudent fiscal policy, also in the medium-term.

While staff notes that fiscal policy was tight in 2018, Messrs. Heo, Shin and Kim explain that Korea's fiscal policy will continue to be expansionary both in 2019 and in the medium term. They explain that the 2019 budget includes an expenditure increase of 9.5 percent, and that the supplementary budget together with the grants disbursed to local governments will provide an additional fiscal support of 0.9 percent of GDP. Beyond 2019, we note that an increase in fiscal expenditure by about 7 percent per year is planned, in line with the authorities' 2018-2022 National Fiscal Management Plan. These fiscal efforts are significant and will reflect in a rising expenditure to GDP-ratio (from 21.5 percent in 2018 to 23.1 percent in 2020). While we welcome the authorities' efforts to use these additional expenditures to further enhance social safety nets, we also agree with staff that the authorities should ensure that additional spending will be fiscally efficient. In this light, we wonder whether there is enough short-term absorption capacity for an even faster expenditure increase as suggested by staff and whether this could not undermine fiscal efficiency.

Second, we note that the current account surplus has significantly declined from 7.6 percent in 2015 to 4.7 percent in 2018 and that a further gradual decline can be expected. We concur with Messrs. Heo, Shin and Kim's request to staff to keep refining the model and reflect on country-specific factors such as rapid population aging and potential reunification costs in assessing the external position.

Third, we appreciate the recent improvement of Korea's female labor force participation rate but continue to agree with staff that further efforts to encourage labor market participation of women as well as youngsters are needed.

Fourth, as staff rightfully highlights, Korea has been at the forefront in using macroprudential policies to manage financial conditions. We welcome the authorities' efforts to use the macroprudential toolkit to address rising household debt through the use of loan-to-value, debt-to-income and debt service ratios. including in the non-banking sectors as of this year. We look forward to learning more about Korea's experience with non-bank macroprudential policy.

Mr. Trabinski and Mr. Heim submitted the following statement:

We thank staff for their informative report and Messrs. Heo, Shin, and Kim for their helpful buff statement. South Korea's economic fundamentals remain robust, despite a weak start into 2019. External headwinds have weighed on output, and higher uncertainties had a negative effect on investment spending and manufacturing, leading to a slowing of economic momentum. While geopolitical risks have declined somewhat overall, the growth outlook for the short term is likely to remain subdued. In the longer term, structural issues, including adverse demographics, rising household debt and weak employment growth present the main challenges to Korea's economy.

Against this background, we agree that prioritizing well-targeted fiscal measures could enhance potential growth. We note the differing views between staff and the authorities on the size of the output gap. The fiscal approach as embedded in the 2019 budget and the supplementary budget seem warranted, given South Korea's sound fiscal position. This said, we encourage the authorities to focus on policies that are well-targeted, efficient and support a more comprehensive safety net. Furthermore, policy makers should opt for prudence by adopting fiscal policies that ensure long-term sustainability and enhance potential growth.

In the light of low inflation and the slowing economic dynamics, the current expansionary monetary policy stance seems appropriate. Last year’s policy rate hike, in combination with a downward shift of the neutral real interest rate, has moved the BOK’s policy stance close to neutral based on staff calculations. At the same time, there is considerable uncertainty around the calculation of the neutral rate, and we would thus tend to agree with the authorities that the current policy rate is adequate. If low inflation and the weakening of the economic climate continue to persist, the BOK may consider staff’s recommendation of a more accommodative policy stance, supported by well-tailored macroprudential policies. We also note BOK’s financial stability concerns and agree that any measures would need to be considered in view of the central bank’s double mandate.

With respect to the preliminary 2018 external sector assessment, we share the authorities’ view in the buff that demographic factors play a significant role in explaining global imbalances and that work on this subject deserves further emphasis.

The financial sector remains sound, but high household debt calls for vigilance.

We welcome recent measures to further strengthen macroprudential policies to bolster resilience, particularly against risks stemming from household debt. In this context, the tightening of the loan-to-value and debt-to-income regulations on mortgage lending, as well as the planed introduction of a household-based counter-cyclical capital buffer, are steps in the right direction.

Further efforts to address labor market inefficiencies remain necessary. Given the weakening of employment growth and the persisting duality in the labor market, we support staff’s call for structural reforms to improve flexibility and security in the job market. As part of an active labor market policy, we see merit in boosting youth employment as well as female labor market participation. Staff rightly points out that a more focused support of training, education and employment services would be more beneficial than direct subsidies to companies. Also, we see a need for caution against minimum wage increases and agree that next year’s adjustment should be set below labor productivity growth in order to mitigate adverse effects on employment.

We encourage the authorities to continue easing the regulatory burden for firms and promoting liberalization of product markets. The results of authorities' past efforts to reduce regulatory hurdles and to strengthen liberalization are encouraging. Nevertheless, the level of product market regulations is still high according to OECD data. Therefore, we see merit in further reform efforts to reduce entry barriers and to cut the administrative burden for new firms and foreign companies. We welcome the recent introduction of regulatory sandboxes for selected sectors, as well as the authorities' commitment to boost innovation in start-ups. Equally, ongoing efforts by the authorities to promote the SME sector are essential to strive for higher productivity and foster inclusive growth.

Ms. Mahasandana and Ms. Latu submitted the following statement:

We thank staff for a comprehensive set of reports and Messrs. Heo, Shin and Kim for their informative buff statement. Korea has strong economic fundamentals with adequate fiscal space, low inflation, high foreign exchange reserves, and sound financial system. However, the economy is facing cyclical and structural headwinds such as an aging population and slow productivity growth, as well as adverse global developments, especially China's economic slowdown, the US-China trade tensions, and the persistent duality of the labor and product markets. These challenges are weighing on Korea's long-term growth potential and call for well-calibrated macroeconomic policies and well-sequenced structural reforms to raise productivity growth, enhance job creation and promote inclusive long-term growth. We broadly share the thrust of staff's reports and offer the following remarks for emphasis.

An expansionary fiscal policy remains appropriate in the medium term to support long-term growth given the significant fiscal space and comfortable debt position. We welcome the authorities' commitment to achieve their growth target for 2019 including the introduction of the supplementary budget. We agree with staff that fiscal policy should focus on social protection, job creation, and growth-enhancing structural reforms. This would also contribute to closing the negative output gap. In view of the aging population, we agree with the adoption of appropriate revenue mobilization measures in the longer term to provide sufficient fiscal buffer to meet any necessary outlays for pensions and healthcare. Better articulation of the proposed tax reforms is encouraged to ensure they do not undermine the country's growth prospects. Can staff comment on the authorities' reservations and the associated plans to enhance the parameters for the output gap assessment, particularly on the observation that the result was highly dependent on the labor market slack indicator and the unstable relationship between the business cycle and employment?

Monetary policy should remain accommodative to underpin growth as inflation remains subdued. We agree with the authorities that this should be balanced against any adverse implication on financial stability as household debt levels remain elevated. The authorities underscored the high uncertainty in staff's estimation of neutral real interest rate and provided additional information to justify their own estimates of neutral real interest rate. Staff's comments are welcome. We welcome the authorities' commitment to maintaining exchange rate flexibility and limiting foreign exchange interventions to addressing disorderly market conditions. We encourage staff and the authorities to continue to monitor developments following the publication of foreign exchange intervention data, and its implication on policy effectiveness. Despite the staff's justification of its preliminary 2018 external sector assessment (Annex I), the authorities continued to express their reservations that the EBA model did not consider some Korea-specific factors like in the previous Article IV consultation. The authorities stated that excess savings were required in view of future challenges arising from demographic change and possible reunification. Can staff comment on how such country specifics have been factored into the EBA assessment to mitigate the authorities' continuing concerns? With respect to past staff responses stating that work to further refine and improve the EBA methodology is underway and that the current methodology including the assessment of demographic effects is under review, it is important that the follow-up actions from the last consultation on the use of the EBA model have been duly informed. Can staff provide an update on this please?

The adoption of appropriate macroprudential measures coupled with vigilant financial sector supervision are key to maintaining financial sector resilience. While the banking system remains sound, prudent macroprudential measures would help contain risks from high household debt in light of the downside risks to the baseline. We take positive note of the regulatory reforms imposed to address financial stability risks and strengthen the resilience of the financial system. We expect the forthcoming FSAP to examine the effectiveness of the financial system oversight framework including the adequacy of the current prudential policies and reform measures in mitigating systemic risks. We note that staff's and authorities' views continue to differ on the CFM/MPM classification of the pre-emptive measures (levy on non-deposit foreign currency liabilities and a leverage cap on FX derivatives) as in the previous Article IV reports, and we therefore urge staff to consider that any alternative measures should be tailored to Korea's circumstances. The careful consideration of the appropriate timing of introducing such measures would also be crucial.

Steadfast implementation of the necessary structural reforms is critical to boosting job creation and promoting inclusive and sustainable long-term growth. We are encouraged by the authorities' progress with its labor market reform agenda and we agree with staff on the need to periodically review the effectiveness of the existing measures in promoting productivity. Furthermore, we agree with adopting flexicurity as a basis for labor market policies to yield an adequate balance between incentives, support and protection for all labor market participants, and thereby boost productivity. Continued engagement between staff and the authorities as well as drawing on the expertise of other relevant international institutions (e.g. International Labor Organization) would be vital in striking the right balance between flexibility and security in order to ensure fiscal viability of the labor market policies is maintained. We support the ongoing efforts to enhance women's participation in the labor force and boost youth employment. This is particularly important in light of the aging population. In terms of product market reforms, we welcome the introduction of the regulatory sandbox and efforts to foster innovation, and we encourage the ongoing implementation of the policy efforts to diversify the manufacturing sector and deregulate the non-manufacturing sector. Besides promoting competition and foreign investment, Korea's long term growth potential would be improved and its vulnerabilities to global developments can be reduced.

Mr. Castets and Mr. Sode submitted the following statement:

We thank staff for the quality of their documents and Mr. Heo, Mr. Shin, and Mr. Kim for their insightful buff statement. We agree with staff that Korea's economic fundamentals remain strong but that more could be done to support domestic demand in the context of weakening external demand, while pursuing medium term reforms towards a more inclusive growth model. While we broadly support staff analysis and recommendations, we would like to make the following comments for emphasis:

Assessing the cyclical position of Korea. We welcome staff Selected Issue Paper on the assessment of output gap in Korea. Taking into account broader measure of employment slack to measure output gap is relevant, notably in the context of the flattening of the Philipps curve when measured with unemployment rates. Such methodological improvement should be applied to other geographical areas and notably to the eurozone, where existing measures of output gaps sometimes look at odds with the perception about the state of labor market. In addition, we think output gap measures of the IMF should be more frequently assessed against their predictive performance regarding inflation. Estimation techniques based on relatively inflexible trend process of variables capturing labor market conditions, such as the one proposed by Jarociński and Lenza (2016)4, could notably better capture the true cyclical position of the economy in real time.

Fiscal and monetary policy stance. We agree with staff that given the cyclical weakening currently observed and the fact that all the conditions are met to support internal demand (ample existing fiscal space, significant current account surplus, low to non-existent inflation pressures), the authorities could adopt more expansive fiscal and monetary stances. Could staff elaborate on the gap between the government current fiscal stance and the one that staff would deem appropriate, notably against the background of the latest disappointing economic data? On the monetary front, we also agree with staff call for a more accommodative stance to prevent a weakening of inflation expectations. Could staff elaborate on the monetary policy measures they would recommend to ensure a sufficient level of accommodation? We also commend their use of macroprudential tools which, as staff analysis shows, has been effective in reducing financial stability risks. Hence the authorities should continue to fine-tune the use of these instruments, notably to complement a more expansionary monetary policy.

Further reducing external imbalances. We welcome the rebalancing of the current account surplus over the last year while noting that according to staff it remains moderately stronger than its fundamentals. Maintaining the flexibility of the exchange rate and supporting further domestic demand hence remain necessary for Korea to reach its macroeconomic internal and external balances. These policies are also the best answers to the heightened trade tensions the country is facing.

Increasing social protection through greater revenue mobilization. We welcome the authorities' commitment to "income-led growth" and a more inclusive growth model. Strengthening social spending on social safety nets, health, childcare support and active labor market policies will help reduce income inequality. If the detrimental impact on employment of rising minimum wage is confirmed, in-work tax credits should be developed further to increase the purchasing power of low-paid workers. On staff's specific recommendation regarding the minimum wage level, we note that Mr. Heo, Mr. Shin, and Mr. Kim underline in their buff statement that the high portion

[4] See ECB working paper Jarociński and Lenza (2016) "An inflation-predicting measure of the output gap in the euro area".

of low-wage workers (receiving less than two-thirds of median income). In this regard, we would be cautious in setting the OECD average minimum to average wage as a benchmark and would have needed more development in the report to better understand how the minimum wage level evolved compared to productivity gains over the recent years – staff comments are welcome. We agree with staff that given its low tax to GDP ratio, Korea has the space to increase public revenue without weighting excessively on growth and that increasing progressive taxation could help to fight income inequality.

Toward an inclusive growth model. We thank staff for their interesting study on how to boost employment in Korea. Given the existing gap between male and female labor participation, increasing female labor force participation is indeed a priority. Family-friendly policies, such as public spending on early childhood education and care are instrumental in this regard. By improving the work-life balance, the new regulation on working hours, which reduces the weekly working hours from 68 to 52, should also boost FLFP. In parallel, improving competition in the product market could also increase productivity and provide more economic opportunities outside of dominant corporations. We particularly appreciated staff's analysis in this regard and would hope that it could be replicated in Article IV assessments for other OECD economies.

Transition toward a low carbon economy. With close to 12 metric tons of CO2 emission per capita and an energy mix that heavily relies on fossil fuels, Korea economy is relatively carbon-intensive. We commend the authorities for putting in place one of the most comprehensive emission trading scheme since 2015 to help the transition toward a low-carbon economy. We wonder whether staff has discussed with the authorities Korea's mitigation strategy to reach the Paris agreement pledges and whether some lessons have been learned from the ETS experience so far?

Mr. Geadah and Ms. Choueiri submitted the following statement:

We thank staff for the reports and Messrs. Heo, Shin, and Kim for their helpful buff statement. Against a background of moderating short-term and potential growth, staff recommends a package of macroeconomic, financial and structural policies to support growth, raise potential output, and reduce internal and external imbalances, while preserving financial stability. We broadly agree with the staff appraisal and have a few comments on the fiscal and financial sector areas.

The authorities have used supplementary budgets to increase spending in the past few years, and government spending is expected to increase by 1.2 percentage points of GDP in 2019. A supplementary budget bill of 0.4 percent of GDP was also submitted to the National Assembly last month. Notwithstanding staff's recommendation for a slightly more accommodative stance in 2019, we welcome the authorities' commitment to take the necessary measures to achieve their growth target this year.

We welcome the concurrence of views between the authorities and staff on the need for medium-term fiscal expansions to focus on enhancing social protection and labor productivity. The authorities recognize the need to reform the tax system and increase revenues in the longer term. However, they are concerned about increasing the neutrality of corporate income taxation, including the impact of a reduced number of tax rates on SMEs. What are staff's views on the authorities' suggestion to streamline existing tax reductions and exemptions, including the possible yield of such a measure? We agree with staff that in the longer term, fiscal challenges from an aging population will necessitate greater revenue mobilization.

Although lending to households slowed down significantly in 2018, the household debt-to-disposable income ratio increased to about 160 percent, and close to 70 percent of that stock is at variable rate. Tighter macroprudential measures (MPMs) have successfully curbed some of the riskier lending, slowed household debt growth, helped to moderate the rise in house prices, and overall, strengthened the resilience of the financial system. We welcome the introduction of the debt service ratio as a controlling indicator for the banking sector, in addition to the loan-to-value and debt-to-income ratios. We note the difference of views between the authorities and staff on a potential role of monetary policy in complementing MPMs. Can staff indicate if they discussed with the authorities other measures to slow the growth in lending to households, including on the supply-side?

Mr. Jin and Ms. Liu submitted the following statement:

We thank staff for the comprehensive set of reports and Messrs. Heo, Shin, and Kim for the informative buff statement. The Korean economy lost growth momentum in 2018, driven mainly by the slowdown in global trade and a domestic contraction of investment in equipment and construction. The economy continues to face longer-term structural challenges. Nevertheless, the Korean economic fundamentals remain strong with a stable financial system and low public debt. The authorities have been taking various measures to boost job creation and push forward structural reforms to sustain long-term growth. We broadly agree with the thrust of staff's appraisal and would like to limit our comments to the following.

A more expansionary fiscal stance is warranted given the decelerating growth and substantial fiscal space. Staff assess that growth is expected to decline to 2.6 percent in 2019, with downside risks coming from both external and domestic sides. Given the strong fiscal position with low level of central government debt, Korea has substantial fiscal space to implement a more active fiscal policy. We agree with staff that the fiscal stance should be expansionary, and more fiscal stimulus through a supplementary budget is needed in the short term to boost employment and growth. We take positive note that the authorities share the view on expansionary fiscal policy with a large increase in expenditure and a supplementary budget bill. We welcome the authorities' commitment to taking necessary measures to boost job creation and further enhance social safety nets. We stress the importance that transfers should be targeted to the vulnerable groups. We also concur with staff that fiscal spending should focus on training and job services to support employment.

Monetary policy should remain accommodative. We take note of the different views between the authorities and staff. We see merit in staff's argument for easing monetary policy given that the inflation rate remains below target. Nevertheless, given that the inflation expectation assessed by the BOK tends to be very stable and its financial stability mandate, we understand the BOK's policy considerations. We encourage the authorities to strike a right balance among inflation, financial stability, and economic growth. We welcome the BOK's data-dependent approach in its managing monetary policy. Meanwhile, a flexible exchange rate would help mitigate adverse macroeconomic effects.

The financial sector remains resilient. The banking system remains healthy, with capital ratios above the regulatory requirements, liquidity improved, and NPLs lowered. We commend the authorities for implementing the regulatory reforms to address financial risks and enhance resilience, including the introduction of the debt service ratio as a controlling indicator for the banking sector, which will also be applied to the non-banking sectors. Nevertheless, household debt remains a source of concern. We encourage the authorities to remain vigilant and make use of macroprudential policies to contain any risks that may arise.

More efforts are needed to reform the product market to diversify the manufacturing base. The Korean economy has become more concentrated in the electronic industry which contributes almost half of the manufacturing growth, as shown in the SIPs. Meanwhile, trade has become more and more important due to Korea's growing participation in the global value chain. Nevertheless, export growth is projected to be weak due to the weak demand for semi-conductors, and the contribution of net exports to growth is also projected to turn negative this year. Therefore, diversification of the manufacturing base and export markets would help broaden economic growth sources and enhance its resilience to cope with domestic and external shocks. In this regard, easing the product market regulations to allow fair competition could help diversify the manufacturing sector. The recent introduction of the regulatory sandboxes to ease the regulatory burdens on firms is a welcome step. What are the current effective tariff rate and barriers, if any, to FDI, and any subsidies to the agriculture sector?

We concur with staff that "flexicurity" should be adopted in the labor market to mitigate duality, support job creation, and foster inclusive growth. We take positive note that the new regulation on maximum working hours would help improve work-life balance and possibly contribute to higher productivity. We welcome the authorities' efforts to promote innovation in start-ups and R&D to boost productivity growth, as well as measures to strengthen social safety nets. We share staff's view that subsidies to SMEs should be reviewed and focused on spurning innovation. Meanwhile, female labor force participation and youth employment should be further promoted.

Mr. Mahlinza, Mr. Garang and Mr. Ismail submitted the following statement:

We thank staff for their comprehensive set of report and Mr. Heo, Mr. Shin, and Mr. Kim for their informative buff statement.

Strong fundamentals, including a flexible exchange rate and sound financial and economic policies, continue to underpin the vibrancy of the Korean economy. Notwithstanding, growth is subject to a number of downside risks, including weaker external demand, waning multilateralism, heightened household indebtedness, rising financial risks, income polarization, labor and product market duality, and declining productivity growth. Given these cyclical and structural challenges, we concur that policies geared toward enhancing full employment, innovation and income equality should be prioritized, going forward. We broadly agree with the thrust of the staff's analysis and recommendations and would like to provide the following comments for emphasis.

Maintaining an expansionary fiscal policy stance in the medium-term is critical to support inclusive growth. We are encouraged by the authorities' commitment towards this fiscal objective and concur that additional fiscal spending should be channeled towards social protection, augmenting female labor force participation, fostering innovation and supporting other growth-promoting measures. We also urge the authorities to improve spending efficiency. In addition, consideration should be given to addressing fiscal pressures from the aging population.

While exchange rate flexibility has served Korea well, easing monetary policy is appropriate. An expansionary monetary policy stance is justified given that inflation remains below the target of Bank of Korea (BoK) and inflation expectations remain weak. That said, we note that the authorities consider the current policy rate sufficiently supportive and accommodative. Staff comments on the authorities' views would be welcome. We commend the authorities for publishing data on FX interventions on the website of the BOK and encourage them to continue limiting interventions to address disorderly market conditions.

A further tightening of macroprudential policies would help preserve financial sector resilience. Notwithstanding the current containment of the financial stability risks, household debt appears to be on the rise. In this respect, we commend the authorities' plans to extend the debt service ratio limit to non-bank financial corporations in 2019. Further, although the banking system remains profitable and well capitalized with significant buffers, more needs to be done to manage the financial sector risks. Can staff comments on the utilization of the expired Policy Bank Recapitalization Fund as well as the market appetite for this fund going forward.?

Undertaking structural reforms is warranted. In this respect, we are encouraged that the authorities are moving towards adoption of flexicurity as a basis for labor market policies, endeavoring to protect workers while doing more to boost youth and female labor force participation in the labor market. Strengthening regulations, enhancing investment in human capital, offering generous childcare, tackling aging challenges, lowering working hours and realizing flexible work environment, as highlighted in the Selected Issues Papers (SIPs), will go a long way to promote and protect employment. In addition, reducing barriers to entry and curtailing the advantages of incumbency in the product market is required. Finally, we urge the authorities to endeavor to set the minimum wage below the labor productivity growth as suggested by staff.

Mr. Kaya and Mr. Bayar submitted the following statement:

We thank staff for their comprehensive set of reports, and Messrs. Heo, Shin, and Kim for their insightful buff statement. The Korean economy continues to demonstrate remarkable resilience on the back of the authorities' sound macro policies, as well as the strong buffers consistently built over time. We agree that Korea's economy faces a number of cyclical and structural challenges, leading to, among other things, a moderation of growth and less-than-impressive employment outcomes. Nevertheless, we are encouraged by the authorities' vigilance as they stand ready to take the necessary measures to keep the growth momentum in the short run while preserving financial stability, as well as those to uplift economic potential in the long run through addressing structural bottlenecks in the labor and product markets. While sharing the thrust of the staff appraisal, we acknowledge that the authorities' have registered some notable caveats in a number of areas, including the monetary policy, macroprudential measures, and the External Sector Assessment. In this regard, we would appreciate a more nuanced discussion on these areas, as well as detailed coverage of the authorities' views in the main body of the Staff Report. The upcoming Financial Sector Assessment Program should present an opportunity to clarify and address some of these persistent differences of views.

Korea's strong fiscal buffers have created policy space for supporting growth. We welcome that the authorities are effectively using their fiscal space to buttress growth, particularly through strengthening the social safety net. Nevertheless, we tend to agree with staff that even after the spending increases through supplementary budgets, the budget continues to firmly register structural surpluses which could be utilized in a careful and gradual manner to further support growth. We concur with staff that the additional spending should be fiscally efficient, and focus particularly on expanding active labor market policies and targeted transfers to the most vulnerable. Such use of the fiscal space could also help address some of the external imbalances. We note the authorities' reservations about the likelihood of a recurrent revenue overperformance and thus, would appreciate if staff could elaborate more on the desirability of their recommended fiscal expansion (i.e. 0.6 percent of GDP).

A more accommodative monetary policy stance could better anchor the inflation dynamics toward the Bank of Korea's (BOK) official target. We acknowledge the complexity of the task the BOK is endowed with and therefore, respect the authorities' careful delineation of policies. That being said, the persistent undershooting of inflation targets, the presence of a negative output gap – notwithstanding the differences of views on its size, and incipient signs of weakening inflation expectations – could justify an easing of the current monetary stance. We concur that the current tight macroprudential framework has guarded Korea's economy well against possible financial stability risks. As highlighted in the respective Selected Issues Paper, macroprudential policies tend to yield more effective results when they complement the monetary policies and the Korean authorities have commendably benefitted from such synergies through the last couple of decades. In that vein, we wonder whether easing the overall monetary stance while keeping the macroprudential policies tight would erode the complementarities between these two policy frameworks and thus, the financial stability gains?

The exchange rate should continue to be allowed to move flexibly, with interventions limited to addressing disorderly market conditions. We welcome the authorities' firm commitment in this regard, as exemplified by their plans to increase the frequency of the reporting of exchange rate intervention records. On the authorities' measures to cap the leverage on foreign exchange derivative positions and to impose a levy on the foreign currency funding, we note that the authorities differ from staff, as they do not see these measures as residence-based or limiting capital flows and thus, insist on their position to have them classified as macroprudential measures under the Fund's Institutional View. Staff's comments are welcome.

Raising the Korean economy's potential over the long-term calls for a comprehensive structural reform agenda, addressing, inter alia, the persistent duality in labor and product markets. We welcome the authorities' focus on supporting income, creating jobs, and fostering innovation. As staff highlighted, the policy direction should be toward promoting flexibility in formal employment, enhancing the coverage and strength of the unemployment benefits, and more effectively using active labor market policies. To this end, we appreciate the authorities' approach to proceed through social consensus and look forward to seeing positive results, with particular respect to female and youth employment. We agree with staff that promoting competition in the non-manufacturing sector could unlock great potential for sustained productivity gains and therefore take positive note of the authorities' intention to support selected service sectors. We support the ongoing efforts for operational and financial restructuring of distressed firms, as well as the overhaul of the subsidies to the small- and medium-sized enterprises to better allocate resources and foster innovation.

Finally, we encourage the authorities to consider moving to the Special Data Dissemination Standard (SDDS) Plus.

Mr. Raghani and Mr. Alle submitted the following statement:

We thank staff for a set of comprehensive papers and Mr. Heo, Mr. Shin and Mr. Kim for their insightful buff statement.

The strong fundamentals of the Korean economy have helped contain the adverse combined effects of the contraction in key sectors and the slowdown in global trade. GDP growth was still strong in 2018, standing at 2.7 percent, albeit down from 3.1 percent in 2017. Other macroeconomic indicators displayed the same trend, including a narrowing but still large current account surplus, an enviable employment growth and subdued inflation despite a temporary spike. Going forward, the authorities are encouraged to address structural impediments to growth and remaining challenges such as youth unemployment and markets rigidities.

We take good note of the authorities' views on the balance of risks, notably the limited impact of trade tensions and the increased economic resilience. Nonetheless, efforts going forward should be directed towards regaining the economy's momentum to close the output gap. Moreover, sustained efforts are needed to reverse the declining trend of potential growth, including by raising productivity and addressing challenges associated with unfavorable demographics. Given the openness of the Korean economy, the authorities should also remain vigilant on global trade policy developments where significant uncertainties remain.

We support the expansionary fiscal policy over the near to medium-term as a tool to promote stronger and more inclusive growth and to facilitate potential growth-enhancing structural reforms. The authorities should be commended for running fiscal surpluses since 2016, as a result of continued revenue overperformance. The increase in government spending in 2019 and associated fiscal easing are appropriate policy orientations to make growth more inclusive, ease conditions for increased labor force participation and hence boost employment. We concur with staff that fiscal policy and reforms can also play an import role in supporting long-term growth. The envisaged outlays to strengthen social safety nets, buttress job creation and foster innovation go in the right direction. We particularly welcome fiscal programs to support SMEs though attention should be given to selection criteria and efficiency concerns. On the revenue side, we agree that efforts should be maintained to further broaden the tax base and prepare for fiscal challenges linked to population ageing. In particular, the authorities would be well-advised to align some tax rates with peers' and streamline tax expenditures with the view to close the gap of the tax revenue-to-GDP ratio vis-à-vis other OECD countries.

We support easing monetary policy to boost demand while using macroprudential policies to manage financial risks. In the face of a depressing domestic demand and an unfavorable global environment, an accommodative monetary stance is welcome to complement growth-enhancing fiscal policies, particularly as inflation expectations are declining and the output gap remains negative. We encourage the authorities to use well-tailored macroprudential policies—taking into account household indebtedness—to preserve financial stability.

While the banking system and non-bank financial institutions remain sound, vigilance is required to contain financial stability risks that stem from high private sector leveraging. Overall indicators are strong, including banks' capital ratios well above regulatory minimums, sizable buffers, and low NPLs for banks. Nonetheless, measures should be taken to boost banks' profitability. Moreover, the high aggregate corporate leverage, especially the growing lending from the NBFC to corporate real-estate related activities, warrants close monitoring. We share staff concerns that this trend may reflect a migration of loans from household to firms to circumvent prudential regulation; and that a reversal in real estate demand or adverse price adjustments could spur delinquencies for loans in the sector. Do the authorities share these concerns and is there any initiative envisaged to close loopholes in the prudential regulation? Staff comments are welcome.

Raising potential growth hinges on comprehensive labor and product markets reforms. On labor markets, efforts should emphasize measures to provide more flexibility to employment protection regulation and to increase female and youth employment. In so doing, the authorities should draw from the experience of OECD peers, including regarding dismissal of workers, unemployment benefits and safety nets and salaries. In addition, private sector job creation should be incentivized while public sector employment increased only to specific services needed to improve citizens' welfare. Regarding the products markets, we encourage the authorities to step up efforts to diversify the manufacturing sector, including by removing barriers to entry in some industries, fostering innovation and reducing costs for start-ups. The recent introduction of regulatory sandboxes for selected sectors is a step in the right direction.

With these remarks, we wish the Korean authorities success in their endeavors.

Mr. Gokarn and Mr. Siriwardana submitted the following statement:

We thank staff for the detailed reports and Mr. Heo, Mr. Shin, and Mr. Kim for their informative buff statement. Korea has been a premier development success story over the last half century by achieving a remarkable growth and lifting millions of people out of poverty. The country enjoys strong economic fundamentals as reflected by low public debt, ample foreign exchange reserves and stable financial system. However, going forward, Korea faces long-term structural challenges, including unfavorable demographics, declining productivity, a stagnant labor market, changing consumption patterns, growing polarization and income inequality. The continuation of the strong economic position requires adjustments to these developments. In particular, the country needs to adopt policies to increase potential growth and innovation, and gradually stem domestic demand from the export driven economy, given significant headwinds in external demand mainly due to ongoing trade tensions and China's slowing economy. We broadly concur with the appraisal in the staff report and would like to make following remarks for emphasis.

Authorities rightly and proactively plan to use the available fiscal space with low public debt to raise government expenditure under the National Fiscal Management Plan. We agree with staff that the additional expenditure should be on fostering social protection, boosting long-term growth and reducing excessive external imbalances. Increased government expenditure will also be needed for pensions and healthcare for a rapidly aging population and to address increasing inequality. Staff's comments are welcome on the possibility of using short-term fiscal stimulus over and above the planned level, using substantial fiscal space to boost consumption and growth and reduce precautionary savings. Going forward, we note that Korea's government revenue is one of the lowest in the OECD and there is significant space to increase it in the long run, particularly to support the fiscal challenges of an aging population. Hence, we see the importance of enhancing government revenue in the long-term mainly by broadening tax bases.

Staff recommends easing Korea's monetary policy stance. Given the negative output gap, weak inflationary pressures and signs that inflation expectations have started to decline, easing will be appropriate and complement the fiscal measures to support growth. However, authorities are concerned that cutting the policy rate would further reduce policy space to address possible future severe negative shocks, which would be undesirable. Could staff comment?

The financial system remains sound and risks to financial stability seem well controlled. However, significantly high household debt due to a prolonged low-interest-rate environment remains a key vulnerability for financial stability, as a tighter monetary policy would place headwinds on economic growth and raise household and corporate balance sheet risks. Hence, we support staff's recommendation that the macroprudential policy stance be kept tight to contain risks from household debt and ensure resilience of the financial system. In this context, we note that both staff and authorities agree that a mix of MPMs and monetary policy would be more effective in addressing overall financial stability risks.

We note the authorities' reservations on the external sector assessment, arguing the need for considering Korea-specific factors, such as the need to save more in view of future challenges arising from demographic change and possible reunification, in the staff's analysis. Could staff comment? Exchange rate flexibility is important to maintain the international price competitiveness and we commend the authorities for limiting intervention to countering disorderly market conditions, with the support of Korea's strong reserve coverage.

Reorienting Korea's economy towards a more balanced and inclusive one needs further efforts. This is particularly relevant in the context of gradual decline in the labor force. Staff's comments are welcome on the mismatch in the labour market due to the decline in manufacturing amidst growing tech and service economy, combined with an ageing population. We welcome the discussion on reforms towards promoting long-term inclusive growth and job creation in the context of labor and product market reforms. Flexicurity is important in boosting employment and reducing labor market duality. Addressing the rigid labor market regulations on female labor force participation and incentivizing their participation would positively contribute to economic growth, as has been indicated in Box 4. The boosting of youth employment is another priority and we urge the authorities to continue to invest in the public education system and vocational training to address this. The restructuring of corporates, particularly distressed firms, will help reallocation of resources. Measures, such as fostering innovation, are required for these industries to become more competitive in the global market and also to ensure that SMEs effectively utilize their capabilities. We commend the launching of a task force for innovative growth in April, as indicated in the buff Statement and look forward to hearing about their policy recommendations.

With these comments, we wish Korean authorities all success in their future endeavors.

Mr. Rosen, Ms. Pollard and Mr. Vitvitsky submitted the following statement:

We thank staff for the high-quality Article IV report and comprehensive set of Selected Issues papers. While Korea's economy slowed in 2018, it continues to have an impressive growth record that has been sustained over many years. Going forward, Korea's economic model must adapt to maintain high growth by shifting toward a more domestic-demand oriented economy. We are pleased that the authorities have initiated policies to help rebalance the economy and encourage more ambitious action, particularly on fiscal policy and exchange rate adjustment. In this regard, we strongly agree with the staff appraisal in the report.

Fiscal Policy and Structural Reforms

We welcome Korea's more expansionary budget this year, though agree with staff's assessment that Korea has adequate fiscal space to do more to support domestic demand growth. We support staff's recommendations, particularly those that can help smooth the transition to a more flexible labor market and boost female labor force participation. Amid declining potential growth, a combination of well-calibrated fiscal policies and structural reforms can help boost productivity growth and reduce excessive disruptions to the labor market. Still, we would have appreciated more specificity in the Article IV on the sequencing and best practices of implementing Active Labor Market Policies. Drawing on the Special Issues paper on "What Fiscal Policy can do to Increase Employment in Korea," does staff have recommendations?

Monetary Policy

In the past, the macro policy mix has been excessively reliant on monetary policy, and we are pleased to see that the policy mix is starting to shift. Indeed, fiscal policy can play a greater role in supporting output growth and inflation amid an estimated negative output gap. We encourage the authorities to maintain data-dependent monetary policy and clearly communicate their objectives and tools.

External Assessment

External Balance Assessment (EBA): Staff's external balance assessment appears transparent and relatively straightforward to interpret. Annex I clearly presents the EBA calculations and includes a staff EBA adjustment of zero, in contrast to the 2018 Article IV. We praise staff for avoiding ad-hoc adjustments to the EBA methodology, which in the past helped explain away Korea's very large external surpluses.

Korea's 2018 current account surplus is found to be "moderately stronger than warranted" while the 2017 current account balance was "stronger than warranted". The change is a result of both a 1 percentage point decline in the surplus and a 1 percentage point rise in the current account norm. Some of the shift to "moderately" can be explained by slowing exports, subdued investment income, and a fall in the saving rate. A narrower policy gap is also a factor, as Korea is expanding fiscal policy. We would appreciate staff's analysis of the factors behind the increase in the current account norm.

Exchange Rate: We are very pleased to see that authorities have begun to publish FX intervention data and encourage more frequent reporting on a timely basis. As this Chair has long stated, FX intervention in Korea should be publicly disclosed and limited to addressing disorderly market conditions. While Fund staff note that net intervention in 2018 appeared to have been 'limited,' the role of exchange rate appreciation in the report in facilitating external adjustment is downplayed. Given that Fund staff consider the won to be undervalued and the current account surplus to be "moderately stronger than warranted," exchange rate appreciation should be an important factor for external adjustment. On a related note, we would be grateful if staff could clarify how they define "disorderly market conditions" particularly since staff indicate that the authorities only intervene when markets are disorderly.

Capital Flow Measures/Macro-Prudential Measures (CFMs/MPMs): Korea's derivatives cap and FX levy are holdovers from the global financial crisis, and we do not believe that they are consistent with the Fund's Institutional View (IV) of being temporary, targeted, and not taking the place of macro adjustment. We agree with Fund staff that the authorities should consider alternative measures that can address financial stability concerns that do not limit capital flows. We also call on staff to clearly state when policies in IMF member countries diverge from the IV on CFMs/MPMs. Can staff clarify that they consider the two measures to be CFMs/MPMs and identify possible alternative measures that could replace the derivatives cap and/or FX levy?

Publication

We strongly encourage the authorities to consent to publish the Article IV report, which is consistent with past practice and will help demonstrate the authorities' commitment to transparency.

The Acting Chair (Mr. Zhang) made the following statement:

Korea's growth has moderated as the economy faces cyclical and structural headwinds. The authorities are committed to taking the necessary measures to achieve the growth target and strengthen the social safety net. All of these have been welcomed in the gray statements. Also, as highlighted in the gray statements, given the decline in the potential growth in the country and also the rise in income inequality, macroeconomic policies should remain supportive of growth, which is to be complemented by structural reforms that will promote inclusion, productivity, and competition. Many Directors also emphasized the importance of macroprudential policies, which should aim at preserving the financial sector's resilience.

The staff representative from the Asia and Pacific Department (Mr. Feyzioglu), in response to questions and comments from Executive Directors, made the following statement:[5]

I would first like to provide some information on the more recent developments after this staff report was circulated, and then I would like to also highlight a few key policy issues that came out from Directors' questions. We have provided answers to all the questions in written form.

There have been two recent developments. First, national accounts for the first quarter 2019 came out. It showed that GDP contracted 0.3 percent in the first quarter. This contraction mainly reflected a larger-than-expected decline in investment, including public investment. Exports also fell, as we expected. While the staff expected economic activity to weaken, this drop was bigger than what we had projected. What does this mean for our projections?

We do expect some bounce-back in the second quarter of this year. Already there are signs that exports have stabilized, and also public investment and consumption should also strengthen in the second quarter given that the authorities are frontloading their budget expenditure.

---

[5] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

Also, one of the main reasons for this significant drop in the first quarter was investment, and investment is very volatile in Korea. Putting all of this together, we feel that it is too early to lower our growth projections. At the same time, there are downside risks, and they are important downside risks.

The second development was related to inflation. Inflation numbers came up for April, which unfortunately showed continued weakness. Headline and core inflation stood at 0.6 and 0.7 percent year-on-year, respectively. These are very low. Importantly, especially for us, one of the key areas that we are very concerned about, inflation expectations, have continued to decline, with the share of those expecting inflation below 2 percent rising to 45 percent of the total population that is sampled, compared to only 31 percent last year.

Regarding policy issues that were raised in the written questions, let me first start with fiscal policy and then switch to monetary policy. Regarding fiscal policy, we are broadly in agreement with the government. Given concerns about growth in the short and in the medium term and external imbalances, we felt that the fiscal balance should be eased more than 1 percent of GDP this year and should continue to be eased going forward. The authorities agree with this principle. In fact, if the supplementary budget goes through the National Assembly the way it was proposed, the fiscal balance will be eased by about 0.9 percent of GDP this year. One part of it is revenue projections. The authorities are also committed to letting the automatic stabilizers work, so if the revenues come in lower because of growth and other reasons, then this decline in the overall fiscal stance would be even larger.

The supplementary budget was not necessarily as high as what we had asked for, but at the same time the government highlighted the importance of fiscal efficiency when they designed this supplementary budget, and we fully support concerns about fiscal efficiency.

Regarding monetary policy, our views differ from the Bank of Korea’s views. We worked hard to explain clearly and correctly the authorities’ views. As we understand, the authorities felt that our description of their views was fine, because we differ. We do think that the Bank of Korea should ease the monetary stance. They do not. We decomposed that argument into several steps, which are in this staff report.

We first looked at the output gap. We both agree that there is an output gap. The output gap is negative, but they feel that our output gap is larger than what they think the output gap is. We both agree that inflationary pressures are weak, so much so that the Bank of Korea's forecast for inflation this year and next year remains below their target of 2 percent. It is about 1.5 percent.

We looked at the neutral real interest rate and we also have some working papers that are coming out related to that. We both agree that it is low. Our numbers, our estimation, we looked at it in so many different ways, and at the end our number is really close to zero, and this is consistent with what we see in other advanced economies. The authorities say their number is between zero and 1. They are comfortable with a ceiling of 1. They get uncomfortable if we argue that it could be below zero. That is their range.

Inflation expectations have been coming down, especially in the last six months, and that worries us because if those expectations are de-anchored, it will be difficult to bring them back up to where they should be. The Bank of Korea recognizes that the inflation expectations have been coming down. They argue that some of it was because of the change in the way the survey is done, but we continue to see this decline, even the latest April numbers show that. They think these expectations will stabilize, but we have not seen it yet.

Finally, financial stability is very important for the Bank of Korea. This is one of their mandates, and they feel that they need to use monetary policy to also guard against financial instability. We argued against that. In our staff report we argued that Korea is one of these great examples where macroprudential policies are working, so the authorities should continue to use them for financial stability; and the Bank of Korea is on this committee that determines the level of macroprudential policies, so it should use its voice there.

The authorities agree that the 0.5 percent of change in the interest rate is not going to make much of a difference in terms of the risk choice of people, but they feel that is a signal they need to give to the markets. The Financial Sector Assessment Program (FSAP) that is coming up will look into this overall framework, and hopefully they will also present some options for how the Bank of Korea can increase its voice in this manner in different ways.

When we put everything together, step by step, at the end we believe that the Bank of Korea should change its monetary stance and loosen and lower the interest rate. Recently, at the most recent meeting, they have removed the tightening bias, so they said now they are at a point where they want to wait and see.

Mr. Castets made the following statement:

We thank Mr. Heo, Mr. Shin, and Mr. Kim for their insightful buff statement and congratulate Mr. Heo for taking up a review so rapidly after joining the Board. We know it is a difficult task. We also would like to thank the staff for a truly excellent Article IV report and for the quality of the selected issues paper.

The Korean economy is currently facing several challenges that warrant a mix of macroeconomic and structural policy measures to move toward a more demand-driven model so as to limit the impact of external shocks on the Korean economy. That is particularly important in the current context of trade tensions, and we start to see the impact also on exports. The staff overall provided a valuable and analytical framework to think through these policy answers, and we particularly appreciated the focus on income inequality but also on the output gap, because it is a question we keep discussing within this Board, and the staff's contribution will inform our discussions of other economies.

First, I would like to reiterate our support for the staff's analysis of the cyclical position in Korea. The output gap assessment is a difficult task, but we feel that trying to measure it through various methods is a good approach that could be replicated for other economies. Ultimately, output gap estimations should be evaluated against their productive power and inflation, and by using broader measures of slack or statistical filters, as the staff does in the excellent selected issues paper. They should be less sensitive to short-term developments, but should also be better able to capture the current inflation evolutions. We strongly encourage the staff to use such methodologies in upcoming reviews and notably for the euro area countries.

Second, with these comments in mind about output gaps and the current cyclical downturn in the first quarter, we support the staff's call for greater fiscal and monetary easing. Given the potential cost of de-anchoring inflation expectations, we are particularly convinced by the staff of the need to act sooner rather than later in terms of monetary accommodation.

Third, on the external balance assessment (EBA), we would like to join Mr. Rosen, Ms. Pollard, and Mr. Vitvitsky in congratulating the staff for resisting ad hoc adjustments to the current account norm. On this issue, we would like to insist on the fact that the current account norm determination has to be done in a way that is strong, analytical, and fact-based. We would like to recall that the EBA methodology, which we modified recently, takes into consideration the demographic shifts, so in the case of Korea, aging. It would be interesting to hear whether the staff discussed the EBA methodology internally with the Research Department (RES) on the latest developments on that side. But our chair will be reluctant to adapt the current account norm based on generic arguments regarding aging, when we feel that this is already fully embedded in the methodology we just agreed on.

Fourth, on the minimum wage, we thank the staff for the answers to our question, but we still think there is a case for more in-depth study, maybe in further reviews, and in particular, we will insist on the fact that the Board needs to have the trend regarding unit labor costs and a comparison between productivity levels, for example, over the past decade to determine whether the recent decisions taken are adequate or not.

Mr. Rosen made the following statement:

The United States and Korea are close friends and trading partners, and we wish them well. We have had remarkable economic success over many decades of strong economic growth. But the economy slowed in 2018 and has slowed further in 2019. As a result, the structure of the economy needs to shift to sustain strong and inclusive growth. We agree with the staff that Korea's current account surplus of 4.7 percent of GDP in 2018 remains large and from the projections, seems to be continuing at that level, which is somewhat concerning.

The staff's estimate of the current account gap is also 1.7 percent of GDP. It seems that there is excessive savings and insufficient public and private investment. This does not fully support balanced global growth and trade. It is also not in Korea's interests, and the economy needs to shift to be more domestically orientated. There is a need to pull the fiscal policy lever to reorient the economy and reduce the current account surplus, and we believe that with a fiscal surplus of 2.7 percent of GDP in 2018, this may have been too tight for the good of the economy, and we are glad to see that the surplus is expected to decline in 2019.

We agree with the Fund's staff on steps to boost female labor force participation and facilitate labor reforms, including a more flexible labor market, which should help to boost potential growth back hopefully to the 3 percent level from which it has fallen.

We also agree with the staff that there should be a relaxation of monetary policy. We are happy to see that the foreign exchange intervention was limited in 2018, and we continue to believe that exchange rate adjustment can play a significant role in shifting the economy and reducing the current account surplus.

Finally, we are pleased that Korea has started to publish foreign exchange interventions on a regular basis, and we strongly encourage more frequent reporting.

Ms. Mahasandana made the following statement:

We thank the staff for the report and responses to our technical questions and Mr. Heo for his buff statement. We welcome the authorities of Korea for the noble growth record sustained over the past years, and we welcome their commitment to implement the necessary policies and reforms to support the growth momentum in the short term while preserving financial stability as well as to boost its long-term growth prospects through addressing structural bottlenecks in labor and product markets. We have some brief remarks for emphasis, which maybe differ slightly from what the other Director just mentioned.

We acknowledge the challenges and high uncertainty associated with undertaking external balance assessments. Recognizing the need to strike the right balance with maintaining evenhandedness, we agree with the authorities that country-specific factors should be adequately taken into account in the EBA model, particularly the demographic challenges weighing on Korea's long-term growth potential.

We welcome the staff's written response that there have been some enhancements to the EBA methodology since the 2018 Article IV consultation in relation to certain fundamentals and policies which have informed the assessment. However, the authorities have persistently expressed their reservations, stating that Korean-specific factors have not been fully taken into account in the EBA.

We take positive note that EBA methodology will be refined further. Given that no definite timeline has been provided, we suggest that the staff give priority to this review, as it is relevant not only to Korea but also other economies. As Mr. Mozhin's gray statement noted, with the EBA model still being refined, a cautious approach should be taken when drawing a conclusion on Korea's external positions, particularly when country-specific factors are not fully captured in the EBA model.

My second point relates to the staff's recommendation for monetary policy. We appreciate the staff's elaboration regarding the neutral rate in the answer to the technical questions, but the different views between the staff and authorities on this signify that it has to be a policy recommendation around an estimate that is subject to large uncertainty.

We tend to agree with authorities that an accommodative monetary policy stance should be balanced against any adverse implications for financial stability, especially as household debt in Korea remains elevated. Here we echo the view expressed in the gray statement from Mr. Merk and Ms. Levonian and would stress that further easing will need to be carefully considered as part of the overall policy mix, taking into account current macroeconomic strengths, financial stability risks, and the need to preserve policy space for future shocks.

Mr. Saito made the following statement:

We thank the staff for the comprehensive report and the supplementary information and Mr. Heo, Mr. Shin, and Mr. Kim for their informative statement. As we issued a comprehensive gray, we would like to limit our remarks to the following three points.

First, on the monetary policy, we support the Bank of Korea's views that macroeconomic conditions and financial stability risks should be considered in a balanced manner. Having said that, we note that the inflation has been persistently undershooting the central bank's target, and there are signs that inflation expectations have started to decline. If the decline in inflation expectations is consistent, the cost of not easing can become larger than the benefit of preserving policy space because it could de-anchor the inflation expectations further and create a need for even larger adjustment, as the staff rightly pointed out. Therefore, we encourage the authorities to monitor carefully the developments of inflation expectations and ease monetary policy if needed.

Second, a related topic is the importance of the Integrated Policy Framework (IPF) by the Fund. To manage financial risks, authorities have taken monetary and macroprudential and capital flow management policies. Furthermore, we see the difference of views between the staff and the authorities on the monetary policy stance and appropriateness of the capital flow measures (CFMs). We believe that this divergence in views calls for a more systematic assessment of an effective policy mix. In this context, we agree with Mr. Moreno and Mr. Montero that the Korean situation makes a strong case that we urgently need an enhanced IPF to make better policy recommendations. While the recent Global Policy Agenda (GPA) describes that IPF as being developed through modeling, empirical work, and the review of the country experiences, we wonder if Korea's experience has been reviewed in the context of the IPF, and if so, what lessons have been learned from the experience. We welcome the staff's comment on this.

Third, on the structural reforms, to mitigate labor market duality and support job creation, we welcome the authorities' efforts to promote labor market stability and flexibility. However, we are concerned that the significant increase in the minimum wage for the past two years seemed to have adverse impacts on employment, particularly for small- and medium-sized enterprises (SMEs). We expect that the new minimum wage-setting framework will better reflect economic conditions.

In the longer-term, Korea would face challenges from declining fertility rates and an aging population. We welcome that the authorities have laid out a plan for addressing these challenges and encourage the staff to make further analysis on the effectiveness of the measures in the future Article IV consultation.

Mr. Merk made the following statement:

We thank the staff for the excellent set of reports and their introductory remarks. We thank Mr. Heo, Mr. Shin, and Mr. Kim for their helpful buff statement. We have issued a detailed gray statement, so I have only a few remarks mainly for emphasis.

First, on the monetary policy stance and risks to price stability, we are reluctant to sign on to staff's recommendation of further easing. While the outlook has slightly weakened, we tend to share the authorities' view that the current monetary policy stance provides for a sufficient degree of accommodation and that some policy space should be preserved at this stage.

Second, against the backdrop of significant downside risks related to trade conflicts, aging, and household indebtedness, we consider a cautious approach of preserving fiscal buffers to be warranted.

Lastly, like Ms. Mahasandana, we consider a cautious interpretation of the EBA results to be appropriate, not least with a view to the demographic challenges the country faces.

Mr. Tombini made the following statement:

I would like to thank Mr. Heo and his colleagues for the helpful buff statement and the staff for this excellent set of reports and for the candid intervention. I also appreciate the focus on macroprudential policies and the risks to financial stability in the Korean economy in the selected issues paper. I will make three comments.

First, on the output gap and policy framework, we take note of the difference between authorities and the staff regarding the estimation of the output gap and its implications for policy recommendations. While current monetary and fiscal conditions remain accommodative in the near-term, we see merit in evaluating options for further easing to support growth considering the available policy space, the challenging external environment, and the acute moderation in economic activity in the first quarter of this year. Against this background, we commend the Bank of Korea's commitment to closely monitor any changes to macroeconomic and financial conditions and take a data-dependent approach toward managing monetary policy.

Second, on the external sector, despite the expected decline in Korea's current account surplus, the economy continues to hold a strong external position underpinned by high integration into global value chains and backed by high levels of international reserves.

We agree with the authorities that the excess of savings reflected in the external position will provide valuable leeway to deal with the rapid population aging, as in other advanced economies. In the case of Korea, an additional element that justifies excess savings is the potential cost of reunification in the Korean Peninsula, as mentioned by Mr. Heo and his colleagues in the buff statement. In this regard, we tend to share the authorities' reservations regarding the staff's assessment of Korea's external position.

Finally, I just wanted to support the point made by Mr. Rosen in welcoming the publication of foreign exchange interventions in the case of Korea.

Ms. Collura made the following statement:

I would like to thank the staff for the very good set of papers and Mr. Heo, Mr. Shin, and Mr. Kim for their helpful buff statement. I appreciate this new format of the meeting with staff explaining progress and answering additional questions at the beginning of our discussion. I will make a few points for emphasis.

We share the staff's view about the need for additional fiscal easing in 2019 and beyond to the extent that fiscal efficiency allows. As noted in the answers to technical questions, outlays for pensions and health care will increase rapidly, especially after 2030. The staff's projections indicate that until that moment, the debt-to-GDP ratio is expected to remain around 40 percent. We believe that the Korean authorities have a window of opportunity to realize all the necessary reforms that would help lift potential output, support inclusiveness, and help the economy to manage an aging population. Using the fiscal space to support reforms is one, but also the use of fiscal space at the current juncture is something we encourage. As we noted about the recent data, we need to support growth in the short term to stimulate further reforms.

In this vein, we believe that monetary policy should follow the same flow. Considering all the arguments about the inflation expectations, I fully associate myself with the remarks made by Mr. Saito about pros and cons. In these specific circumstances, the policy mix should move toward the same goal.

Let me reiterate again that we appreciate the staff's analysis about the output gap, about figuring out more comprehensive measures for the labor market slack. I was particularly tempted by the fact that the Phillips curve seems to work better if we expand the way we assess this slack. Like Mr. Castets, we encourage the staff to test the robustness of this model of the economy, including in the euro area.

Finally, on the external sector assessment, we have the feeling that the EBA refinements help capture better the external assessment position of Korea. Considering the debate around this issue, I would like to understand from the staff to what extent, if any, these refinements are not able to capture the issue of population aging in the context of Korea, because my feeling is that if we consider more country-specific factors, capturing population aging, we might risk doubling aging.

Like Mr. Tombini and Mr. Rosen, I congratulate the authorities for the application of their foreign exchange intervention, and I also encourage them to do more. Finally, I noted that the authorities have not yet decided to publish the Article IV report, and I would appreciate an update on that.

Mr. Trabinski made the following statement:

We thank the staff for a comprehensive set of reports, especially for well-drafted selected issues paper, and Mr. Heo, Mr. Shin, and Mr. Kim for their informative buff statement.

We commend the Korean authorities for their efforts that contributed to strong economic fundamentals. At the same time, Korea's economy faces considerable structural challenges and external headwinds that require continuous reform efforts to ensure inclusive and long-term growth. We issued a gray statement, so let me stress two points for emphasis.

First, like Mr. Merk, we are of the view that the current monetary policy stance provides for a sufficient degree of accommodation and that some policies should be preserved at this stage. That being said, should low inflation and the weakening of the current economic conditions persist, or in the case of a severe external shock, the authorities may want to consider an easing of the policy stance in line with the staff's advice.

Second, on structural reforms, we deem it crucial to put more emphasis on the role of SMEs and startups as drivers of innovation. There is a need to step up efforts to enhance the performance of SMEs, whose labor productivity in the manufacturing sector has fallen significantly compared to large companies. Such efforts should go hand in hand with the further relaxation of the regulatory burden of SMEs and further reforms of the education system to reduce labor market mismatches. With this, we wish the authorities all the best.

Mr. Kaya made the following statement:

We would thank the staff for the well-written set of reports as well as for the informative introductory remarks. We thank Mr. Heo, Mr. Shin, and Mr. Kim for their insightful buff statement. In addition to our written statement, I would like to highlight three points.

First, on fiscal policy, given Korea's strong budget position and comfortable public debt levels, we agree with the staff that the more accommodative stance could better buttress economic activity, including through enhancing social protection, addressing inequalities, and uplifting long-term growth, while at the same time helping to mitigate external imbalances.

We appreciate the increased granularity in the staff’s analysis and are confident that the authorities will take this into account when crafting their final policies. To that effect, we are encouraged that the authorities have already planned to use in a prudent manner the available fiscal space through their National Fiscal Management Plan.

Second, on monetary policy, we appreciate the complexity of challenges facing the Bank of Korea and welcome their cautious approach, which has served the economy well so far. Notwithstanding the differences of view between the staff and the authorities about the size of the output gap, both sides agree that there exists a negative output gap. Moreover, low headline figures owing partly to supply-side factors could lead to a weakening of expectations and thus further complicate the central bank’s task. We therefore believe a well-calibrated monetary easing could better anchor the inflation dynamics. We agree that macroprudential policies should remain tight to contain financial stability risks, particularly those emanating from household indebtedness, and we commend the authorities’ effective use of these measures so far. We also appreciate the wealth of analysis provided by the staff on the subject, which could also lay the ground for a more substantive discussion in the future.

Finally, we welcome the authorities’ commitment to the flexible exchange rate regime as well as the recent steps to improve the transparency of their intervention. We also take note of the persistent divergence of views on the authorities’ policies, which are assessed by the staff to be both macroprudential and capital flow measures (MPM/CFM). This issue has been a source of contention between the authorities and the Fund and OECD staff for several years. That being the case, as also answered by the staff’s written responses, the Fund is not yet able to suggest concrete alternatives which will sufficiently curtail financial stability risks without limiting capital flows. We therefore look forward to a more granular discussion on this subject as part of the forthcoming FSAP missions. With these remarks, we wish the authorities all the success in their endeavors.

Mr. Moreno made the following statement:

We welcome the staff's paper and Mr. Heo's buff statement, and like Mr. Castets, I commend Mr. Heo for dealing with an Article IV meeting only two weeks after joining the Board.

Like most Directors, we believe that there is a relatively sound macroeconomic framework despite the cyclical downturn, and we completely share the staff's proposals to ease monetary policy. I would like to echo Mr. Saito's comments. We have also stressed in our gray statement the possibility of taking into account non-conventional monetary policies for future discussions with the authorities. We also support the staff on the use of fiscal policy, and we believe that there is enough fiscal space to increase revenues by the authorities without having a significant impact on growth. Like Mr. Castets and Mr. Rosen, we echo the importance of having more demand-driven growth, which would also have an important impact on external imbalances in reducing the large current account surplus of Korea.

We particularly welcome the staff's focus on boosting potential growth and having more inclusive growth. Korea is the twelfth-largest economy in the world. It is time to focus more on growth and inequality. This goes to the issue of emerging versus advanced economies. Korea has higher GDP and higher GDP per capita than Spain, so it is time for Korea to really focus on inequality, and I would like to highlight a few issues that we also suggest in our gray statement.

The first is the issue of gender. It is striking. This is the lowest female labor force participation in advanced economies and one of the largest pay gaps. We very much welcome the focus of the staff. I understand that most of Directors have highlighted it in their gray statements, so it is something that should be reflected in the summing up.

On the minimum wage, we welcome the staff's responses, and here it is more an issue for the Strategy, Policy, and Review Department (SPR) because this is an issue that we are finding in many countries now. Many of us are increasing minimum wage. There is wide support in society for the increase in minimum wage. In the case of Korea, there is in-work poverty and rising inequality, so when we analyze the minimum wage, we have to take into account a holistic approach, not only the efficiency component of it but also how it can affect reducing inequality—even more generally for all countries, and we have a large debate on this. There is an interesting setup in Korea in terms of large inclusion of many representatives to deal with it, but we will please ask SPR to look into this because the response that was given is a theoretical one. We thank the staff, but we need to take a closer look at this in every single country.

One of the most important issues in Korea is the barriers to trade and foreign investment. This is something that also should be listed, and the authorities should take a look at that.

Finally, we have also raised the issue of climate change, and we would welcome the staff's take on climate change issues in future conversations about Korea.

Ms. Levonian made the following statement:

Let me join my colleagues in thanking the staff for a comprehensive report and a rich analysis in the many selected issues papers. I also thank Mr. Heo, Mr. Shin, and Mr. Kim for their helpful buff statement. As we indicated in our gray statement, we support the staff's overall assessment, so I will emphasize only two points.

First, on the issue of trade, as noted by the staff, the recent slowing in Korean growth has mainly been driven by external factors, such as slowing demand from China and the disruptions arising from the U.S.-China trade tensions. Ongoing trade tensions are delaying business investment in Korea and many other economies around the world, which is slowing trade further. The global economy has been dealing with heightened uncertainty over trade policies for quite some time now. The Korean case clearly shows how bystanders with deeply entrenched value chains can be worse off as a result of trade tensions.

Second, as Mr. Rosen and Mr. Moreno have highlighted, on the issue of balanced and inclusive growth, despite recent progress, Korea's female labor force participation is one of the lowest in advanced economies, and the gender pay gap is among the highest in the OECD. We encourage the authorities to continue with their efforts to encourage participation and leadership of women in the labor market and increase economic opportunities for other marginalized groups as well. These efforts could yield significant growth gains given the rapidly aging population and declining productivity growth. With that I wish the authorities well.

Mr. Mozhin made the following statement:

Let first once again thank staff for a set of high-quality papers, and in particular I would want to underline that in this case the staff did not shy away from taking a position on monetary policy. I would be reluctant to to take a position on whether the staff is right or otherwise. We have heard from Mr. Merk, who is not in agreement with the staff, but what I find deserving of praise is a very clear position on monetary policy, which we do not necessarily find in every other country report.

My second point is that we did not receive a written response to a question we asked in our gray statement, and this is on the authorities' plans to expand public sector employment as a way to address challenges related to the aging population. We read in the gray statement that the authorities do have such plans, and we asked the staff to provide us with some further information on that front.

My final comment is that all the fiscal statistics in the report are on the central government data rather than on general government. It is interesting that this has been the case for many years. I raised this question quite a while ago, and what I heard in response was that local government budgets are very small and important, and the authorities may not be even collecting this data. But then when I look at Table 3 on page 33 of the report, what I see is that the table is on a statement of central government operations, but then the very last item is on general government debt. What we see from here is that such data exist, and then we also see that local governments are in deficit. The difference between central government debt and general government debt is on the order of 3.5 percentage points of GDP, which is quite significant. I would encourage the staff to raise this with the Korean authorities, because even from the point of view of making comparisons, it is not clear from the data, which are limited only to central government data, what is the overall tax take, what is the overall share of the budget in GDP, how it is compared to other countries.

Mr. Gokarn made the following statement:

We join other Directors in thanking the staff for an excellent set of papers and their responses to our questions and Mr. Heo, Mr. Shin, and Mr. Kim for a helpful buff statement. We issued a gray statement, but I would like to weigh in on a few points.

The first is the discussion that has gone on in this room on monetary policy versus the stimulus versus the stability tradeoff. It is important and perhaps a more general issue that countries need to deal with. It appears to be that the channel of transmission from an expansionary policy at this point will come, initially at least and perhaps most significantly, through consumption spending, which in turn has an implication for household debt, which clearly from the authorities' viewpoint is a major source of concern from the financial stability perspective.

The argument against expansion now, and Mr. Merk and Mr. Trabinski have highlighted that, is that higher household borrowing at lower interest rates would simply build up the vulnerability in the case of a need to increase interest rates at some point. The greater vulnerability then poses some threat.

Underlying this dilemma is the structure of household debt, the fact that it is predominantly on a floating rate basis, which makes it vulnerable. From a longer-term perspective, and I am not taking a view on monetary policy position like Mr. Mozhin, are there initiatives to reduce household vulnerability through hedging mechanisms of some kind, maybe emphasizing or pushing for fixed-rate loans, which will obviously reduce this degree of vulnerability over time, although it may deter borrowing at the initial stages? That is the sort of dilemma that needs to be resolved in this tradeoff and perhaps there can be some debate on the appropriate mechanisms to do this.

The second issue I wanted to address was the labor market issue, which is very important, and I like the way that this debate has now been placed in the broader context of the Asia and Pacific Department (APD) Regional Economic Outlook (REO) of spring 2017, which had a very detailed chapter on demographics across Asia and their implications for macroeconomic outcomes. These are linking up quite nicely. There are a few points that I wanted to touch on. One is the argument that more flexible labor contracts—this is, as Mr. Moreno said in slightly different context—a theoretical argument. In my experience—and I have studied Korea, I have studied some other countries with this—the rigidity is often offset by a greater degree of variability in pay, in effective wages. For example, the percentage of variable compensation in a typical salary structure is much higher in countries which have fixed permanent contracts. Is that pattern prevalent in Korea now, and does that offer some offset against the argument that flexible contracts are better? Because this is a cultural thing also, it is not easy to move from fixed contracts to variable contracts. We have had the experience of

France recently with the opposition against the first job contract; it is a rather tricky political issue to manage.

The second point is the fact that—and this comes from Chapter 2 of the April 2017 REO—about 60 percent of Korea's workforce is in occupations where productivity declines with age, and so this does pose enormous challenges for efforts to increase productivity overall. Some thoughts on that rather rigid barrier would be quite useful.

Mr. Jin made the following statement:

Although the growth slowed down last year, the Korea economic fundamentals remained strong. The public debt level is low, and fiscal space is substantial. Against this background, the high level of household debt remains a source of concern. We encourage the authorities to keep vigilant and make use of macroprudential policies to contain any risks that may arise, and we wonder how Fund staff evaluate Korea's household debt level compared with other advanced economies and the dynamic emerging market economies.

The staff report discussed subsidies to the SMEs, and we understand that these subsidies are growth-friendly and inclusive by design, and it will be helpful if the report can clarify that these subsidies are WTO-consistent so as to avoid misinterpretation by the market.

Mr. Sigurgeirsson made the following statement:

We have issued a gray statement, and I do not intend to repeat anything from that statement. I would just like to add a point on transparency and join Mr. Rosen and Mr. Tombini and Mr. Kaya on their comments to welcome the publication of the foreign exchange interventions, and in the same spirit, we would like to encourage the authorities to consent to the publication of the report, as mentioned by Mr. Rosen, Ms. Pollard, and Ms. Collura.

Mr. Mahlinza made the following statement:

We thank the staff for the comprehensive set of reports and Mr. Heo, Mr. Shin, and Mr. Kim for their informative buff statement. We have issued a gray statement and would like to emphasize a few points.

First, like other Directors, we have concurred with the staff that easing monetary policy is justified under the circumstances. But like Mr. Mozhin, we would like to thank the staff for the comments further clarifying their position with respect to the monetary policy stance. We find this quite clear and detailed.

Second, on the classification of foreign exchange measures, we note that there have been differences between the staff and the authorities on this for some time now. What we would encourage is continuous dialogue between the staff and the authorities, and we look forward to the upcoming FSAP review.

Finally, in view of the significant labor and product market rigidities, we would encourage the authorities to move quickly toward adoption of flexicurity reforms to allow flexible labor markets and strengthen the social safety nets. We would also support efforts to enhance foreign competition through reducing tariffs and domestic co-financing requirements.

The staff representative from the Asia and Pacific Department (Mr. Feyzioglu), in response to questions and comments from Executive Directors, made the following statement:

In terms of our views on the EBA and how that fits to Korea, we found that the EBA methodology is very useful, very useful for Korea, especially when there is a very large current account surplus. Looking at these numbers, what does this really mean? It created a good structure. In the case of Korea, it is actually more than that. The model fits Korea well. There is a very small residual, if any, in most years, including the most recent one. It fits well. Even more importantly, what it implies makes sense from an economic point of view because the other side of this external imbalance is domestic imbalance. We do believe that domestic demand is not as strong as it could be. This is a very open economy. Many of the resources go to exports and exporting markets. It could do more to strengthen its domestic demand and domestic markets. Overall, the model fits well.

In terms of these additional factors that affect Korea, there are two which are mentioned a number of times. One is demographics, and the other one is unification. In terms of demographics, the model did change recently, and then that led to a larger impact of demographics in increasing the norm in Korea. Should the demographic impact be even more? Not according to estimation, but also because there is no residual, we are having difficulty arguing that the impact should be even more. We believe that with the new methodology, the demographics are handled well, and that is one of the reasons why the norm is positive in Korea.

In terms of unification, the model fits well. The government has been saving for unification for many years, so the fiscal position that the government has been taking for many years is already in the equation. If we were to add another variable, then we start double counting, so that is why we do not think we need to have an additional number for that.

Has Korea been a part of the IPF? Yes, we have been doing some work on that, and what is the outcome from that? It informs the way we try to set up our discussions in the staff report, but what came out was that based on the IPF, there was an even more convincing argument that monetary policy should be looser. That was the main result.

Public sector employment is increasing. It is not very clear because when the new government came to power, it promised a large increase in public sector employment that would be more than 30 percent of what they have. Our sense is that they felt uncomfortable with these numbers, but then again, we did not have any dialogue that we could put in the staff report. Some of what they are aiming for makes a lot of sense. There are certain services where they can have more employment, for example, firemen. They can have more people helping to train those who come out of the labor market to find other jobs. But the idea of just creating jobs for the sake of creating jobs is not something that we would endorse, and the authorities also tend to agree with that. In the end, the actual increase in public employment may be significantly lower than what they might have initially thought.

In terms of general government versus central government, fiscal data is an issue in Korea. We would have loved to have good current local government data. Local government data come with a huge lag, and that is why we cannot wait for that number. We do not have good estimates either. We have discussed this with the authorities, and we continue to encourage them to provide the public this data, and it will certainly help the discussion.

Our impression is that the size of local governments is not that large today, but there is also some talk that the government may increase transfers to local governments. If that is the case, then it becomes even more important to capture this transfer and capture what is going on in the local markets.

In terms of household debt, it is an area that we have been looking at. The share of fixed mortgages, fixed rates were quite low a decade ago, but this has been increasing, and the authorities intend to continue to try to increase the share of fixed rates in household debt, and they are encouraging banks to take steps in that direction. That will certainly help with monetary policy.

In terms of fixed contracts versus variable contracts in the labor markets and the tradeoff, we have to think more about that. Maybe we can respond bilaterally, but it is a good question. On how household debt compares to others, household debt is 165 percent of disposable income, the eighth highest in the OECD, but it is above the OECD average, so it is high. That is another reason why, even though the growth rate of household debt is stabilizing, we believe it is still a risk, and therefore we look at buffers in the banking system if real interest rates go up so high that this may become a stress.

Finally, there was one more question on the labor market. As workers age, their productivity declines. This is a very important issue, and the government is creating jobs for 65-year-olds or older, and it is not clear whether that is productive or not. One of the recommendations we make is to transfer them, and also we have been emphasizing training.

The staff representative from the Strategy, Policy, and Review Department (Mr. Kaufman), in response to questions and comments from Executive Directors, made the following statement:

I can answer Mr. Saito's question on the work on the IPF. Korea is, indeed, one of the cases being analyzed along with others, but at this stage it will be premature to try to draw any general conclusions since the process is ongoing. We are still analyzing other cases, and as has been explained, the work on the IPF will have several legs. The analysis of country experience is one of the legs, and it is ongoing. It has not been done. It would be premature at this stage to try to extract broad lessons.

Mr. Heo made the following concluding statement:

On behalf of the Korean authorities, I would like to thank Mr. Feyzioglu and his team for their excellent work and constructive engagement with the authorities. I would also like to express my appreciation to Directors for sharing useful comments and views in their gray statements and today's meeting, which I will convey to my authorities.

As many Directors already pointed out, the Korean economy has strong fundamentals, but it faces short-term headwinds and major structural challenges in the medium-term. Since I have broadly covered the government's policy directions and major agenda to tackle these challenges in the buff statement, I will limit my comments to emphasizing our views on a few issues.

First, I would like to highlight that the authorities are taking an expansionary stance on the fiscal front, including through a supplementary budget, as suggested by the staff and many colleagues. The Korean government has already submitted a supplementary budget bill amounting to around 0.4 percent of GDP to the National Assembly, which will respond preemptively to worsening economic situations. Combined with grants of about 0.6 percent of GDP which have been disbursed to local governments in April, the level of additional fiscal boosting will be more than what the staff recommended. With this, we are expecting to achieve our economic growth target of 2.6 to 2.7 percent for this year. For the structural issues for the longer-term, which many Directors pointed out, we are encouraging more female labor force participation by increasing childcare benefits, renovating the public and private early childhood education system, and putting in place the regulation of maximum working hours. In the meantime, I would also stress that we put great emphasis on spending efficiency and trying to maintain fiscal soundness over the longer-term in the face of future spending needs arising from aging and possible reunification.

Second, despite the staff's preliminary assessment of a moderately stronger position, we believe it is approaching the balance with its declining current account surplus if we take Korean-specific factors into account. Given the intrinsic limits of the model and uncertainty, we hope that the staff continue to try to refine the model and make additional efforts to incorporate the country-specific circumstances into the analysis. I appreciate that many Directors supported our views in their gray statements.

Following the Fund's recommendation, Korea began to publish the foreign exchange intervention data at the end of March, which showed that very limited interventions have been made during the second half of last year. We will keep reporting the data as planned.

Third, despite all Directors' concerns, we believe the minimum wage policy plays a crucial role in correcting inequality and boosting domestic consumption in Korea's context. We hope the new minimum wage-setting mechanism once approved in the National Assembly will enhance the objectivity and rationality of the minimum wage decision and encourage wider social acceptance as well.

Lastly, to boost the economic vitality, the Korean government has made every effort to drive innovation and to enhance private investment through lifting regulations and promoting fair competition. We appreciate the staff's analysis on product market reforms and will learn from it, but I would like to point out that there has been a significant improvement since 2013 when this OECD regulation data were collected, and we look forward to better research in the assessment based on 2018 data, which will be coming soon. Korea ranked fourth out of 190 countries in the Ease of Doing Business Indicator of the World Bank.

The authorities have decided to publish the staff report immediately after the meeting.

Finally, I would like to express my personal appreciation to Mr. Feyzioglu for his excellent work on Korea for the last years and best wishes on his future endeavors after retirement.

The Acting Chair (Mr. Zhang) thanked Mr. Feyzioglu for his service to the Fund.

The Acting Chair (Mr. Zhang) noted that the Republic of Korea is an Article VIII member, and no decision was proposed.

The following summing up was issued:

Executive Directors broadly agreed with the thrust of the staff appraisal. They noted that Korea's economy has strong fundamentals, supported by robust policy frameworks and a resilient financial system. Nevertheless, cyclical and structural headwinds amid the challenging global environment have hampered growth prospects with risks to the downside. Directors underscored the need for policies aimed at promoting balanced, private sector-led growth; fostering inclusion; and enhancing productivity.

Directors generally concurred that fiscal policy should remain expansionary into the medium term to support growth, job creation, and external rebalancing. They noted that Korea has ample fiscal space for additional stimulus, and in this context, broadly welcomed the planned supplementary budget and the authorities' readiness to take further action as necessary to achieve the growth target and strengthen social safety nets. Directors also saw a role for fiscal policy in promoting women and youth employment, enhancing active labor market policies, and supporting growth-enhancing structural reforms. In the longer term, tax reforms that aim to promote innovation and efficiency in resource allocation could further support growth. Directors also stressed the need for greater revenue mobilization to prepare for the aging population.

Directors agreed that monetary policy should remain accommodative. With inflation projected to remain below target and signs that inflation expectations have started to decline and the output gap remains negative, most Directors saw room for a further easing of monetary policy, while a few Directors emphasized the importance of preserving policy space and financial stability. Directors encouraged the authorities to rely more on targeted macroprudential policies to manage financial stability risks, including from the still high household indebtedness and possible house price corrections. They welcomed ongoing efforts to strengthen the regulatory and oversight frameworks.

Directors welcomed the continued commitment to a flexible exchange rate and the recent step to enhance transparency in foreign exchange policy. Policies and structural reforms that promote domestic demand and private investment would contribute to a further reduction of the current account surplus.

Directors emphasized that reforms in the labor and product markets are key to boosting potential growth. They encouraged measures to enhance flexibility and security (flexicurity) in the labor market to mitigate duality and create jobs in the private sector. They also recommended linking minimum wage increases to labor productivity growth and phasing out compensatory subsidies to small- and medium-sized enterprises. Directors encouraged further diversification of the manufacturing sector and liberalization of the services sector, including by easing the regulatory burden on firms, lowering barriers to entry, and reducing protection of existing firms.

It is expected that the next Article IV consultation with the Republic of Korea will be held on the standard 12-month cycle.

APPROVAL: April 9, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Real

1. We appreciate the staff's efforts to identify more comprehensive ways to assess the extent of the output gap, and we concur with the conclusion that broader measurements of the labor market slack with discouraged workers may be most relevant. To which extent do staff determine that the dual nature of the Korean labor market might have an impact on this analysis?

- While in theory the existence of different employment forms should not affect the analysis, to the extent workers on temporary contracts are involuntarily employed part-time, this would add to the size of labor market slack.

2. ***Can staff comment on the authorities' reservations and the associated plans to enhance the parameters for the output gap assessment, particularly on the observation that the result was highly dependent on the labor market slack indicator and the unstable relationship between the business cycle and employment?***

- Given the theoretical and unobservable nature of output gaps, estimation is sensitive to parameter and model uncertainties, and the results require an element of judgement. In the Selected Issue Paper, staff has attempted to address these uncertainties by considering various measures of labor market slack. In staff's view, a more comprehensive labor market slack is associated with a wider output gap. In the underlying working paper (forthcoming) additional robustness checks will be included.

3. ***Could staff elaborate on the key drivers of the recent growth slowdown? Against this background, do staff see a need to revise their growth outlook or to put more emphasis on the downside risks?***

- The recently released national account numbers showed that the economy contracted 0.3 percent in 2019Q1 (q/q, s.a.). This was in particular driven by a large fall in investment, including public investment. Exports also fell. While staff did expect a softening in demand, the observed decline was larger than projected. Staff expects growth to bounce back somewhat in Q2. There are signs that exports have stabilized in April, and consumption and public investment should strengthen on the back of the planned fiscal frontloading. At the same time, investment is quite volatile in Korea.

Therefore, we believe it is too early to revise down the annual growth rate, but risks remain elevated and on the downside.

External

4. ***Can staff comment on how such country specifics have been factored into the EBA assessment to mitigate the authorities' continuing concerns? With respect to past staff responses stating that work to further refine and improve the EBA methodology is underway and that the current methodology including the assessment of demographic effects is under review, it is important that the follow-up actions from the last consultation on the use of the EBA model have been duly informed. Can staff provide an update on this please?***

5. ***While the staff's external sector assessment shows that significantly more expansionary fiscal policy to boost domestic demand in the short and longer run will help to reduce imbalances, the authorities indicate that the IMF model did not consider some Korea-specific factors, including the need to save more in view of future challenges arising from demographic change and possible reunification. We would welcome the staff's response.***

6. ***We note the authorities' reservations on the external sector assessment, arguing the need for considering Korea-specific factors, such as the need to save more in view of future challenges arising from demographic change and possible reunification, in the staff's analysis. Could staff comment?***

- Since the last Article IV consultation in early 2018, the EBA model has been enhanced inter alia by improving the modeling of certain fundamentals (demographics, institutional risks) and policies (credit excesses and FXI). This has improved the model's fit to Korea, specifically by (i) better capturing the country's high life expectancy and share of prime-age savers, and (ii) reflecting a broader measure of Korea's institutional quality. The EBA model will again be revisited in the coming years, although no specific timetable on future refinements has been defined.

7. ***What are the current effective tariff rate and barriers, if any, to FDI, and any subsidies to the agriculture sector?***

- The lower two charts in Figure 2 of the Staff Report include information on FDI restrictions based on data collected by the OECD and World Bank. In the World Bank indicator, the restrictions to starting a foreign business are measured as days (17) and procedures (11) needed to start a foreign business in Korea. The OECD database includes data on agricultural support in “producer support equivalent as percent of gross farm receipts” (49.2 percent).

8. ***We would appreciate staff’s analysis of the factors behind the increase in the current account norm.***

- The increase in the norm for Korea mainly reflects enhancements in the EBA model specification for demographic and institutional risks. About half of the increase reflects higher contribution from demographics, which now better capture saving from Korea’s high life expectancy and high share of prime-aged savers. The other half reflects a more comprehensive view institutional quality, where Korea ranks relatively less favorably than under the earlier narrower concept. For further reference see recently issued WP: External Balance Assessment Methodology: 2018 Update.

Monetary

9. The authorities view inflation expectations as well anchored, whereas staff sees signs of a decline. Could staff give further details on its assessment of the trend of inflation expectations, also given that real interest rates would be accommodative even by staff’s estimate of the neutral rate if one assumes well-anchored expectations (Box 2)?

10. Could staff elaborate more on how much inflation expectations would be weakened and how serious this would be?

- Inflation expectations tend to track realized inflation, and Korea’s persistently low and declining headline inflation is reflected in declining expectations according to surveys. Some surveys (BOK’s survey of consumer inflation) suggest more recent decline than others (Consensus Economics survey of financial analysts). For example, according to BOK’s survey, inflation expectations have continued to decline with the share of those expecting inflation below 2 percent rising to 45 percent in April, up from 31 percent last year.

- Inflation expectation indicators are imprecise and assessing their implications for real interest rates requires a degree of judgment. Given that realized inflation has been below 2 percent since 2012, it is likely that inflation expectations are also below this level. Moreover, even if expectations were anchored around 2 percent, implying a real policy rate of -0.25 percent, the BOK’s monetary policy stance would still be close enough to the neutral rate to not be firmly accommodating.

11. ***Has staff considered the adequacy of some unconventional monetary policy measures for the Korean case?***

- Unconventional policy measures could become relevant in Korea if a large negative shock would bring interest rates to the lower bound. Considering the adequacy of UMP in Korea is important but has been beyond the scope of this Article IV consultation.

12. ***Could staff elaborate on the monetary policy measures they would recommend to ensure a sufficient level of accommodation?***

- Staff recommend monetary policy easing sooner rather than later to ensure a clearly expansionary monetary policy stance. The size of the policy rate cut would have to deliver a clear message to the market of intentions of easing. The precise timing and the size of the policy rate cut would best be determined by the BoK. Currently, there is sufficient conventional policy space to achieve such easing.

13. ***An expansionary monetary policy stance is justified given that inflation remains below the target of Bank of Korea (BoK) and inflation expectations remain weak. That said, we note that the authorities consider the current policy rate sufficiently supportive and accommodative. Staff comments on the authorities' views would be welcome.***

- The BOK views monetary policy as still accommodating based on their estimates of a neutral real interest rate that is between zero and one, and a real interest rate that is negative. Staff estimates the neutral real interest rate to be close to zero, in line with the literature. Staff's estimate of the real interest rate is also close to zero. Given the closeness of these estimates and recognizing the uncertainly around them, staff view monetary policy as not firmly accommodating.

14. ***In that vein, we wonder whether easing the overall monetary stance while keeping the macroprudential policies tight would erode the complementarities between these two policy frameworks and thus, the financial stability gains?***

- When business and financial cycles are in sync, easing or tightening jointly monetary and macroprudential policies could help complement each policy measure's effectiveness. Currently, the business and financial cycles are moving in opposite directions; therefore, the direction of monetary and macroprudential policies need to diverge. Staff analysis suggests that in cases where real and financial cycle are not aligned, the benefits of complimentary monetary and macroprudential policies diminish.

15. ***However, authorities are concerned that cutting the policy rate would further reduce policy space to address possible future severe negative shocks, which would be undesirable. Could staff comment?***

- If monetary policy is not eased promptly when needed, inflation may decline. This could de-anchor inflation expectations downward, thereby increasing real interest rates and further tightening financial conditions. Declining inflation expectations could set off a deflationary trap and create a need for an even larger rate cut later. A sufficiently large cut may not be possible due to the proximity of the lower bound.

- Cutting interest rates sooner rather than later, before deflationary pressures intensify, would help support inflation and inflation expectations. Higher inflation would allow a return to higher policy rates earlier, thereby putting more distance to the lower bound and creating monetary policy space for addressing future negative shocks.

16. ***The authorities underscored the high uncertainty in staff's estimation of neutral real interest rate and provided additional information to justify their own estimates of neutral real interest rate. Staff's comments are welcome.***

- Staff estimate of close to zero neutral real interest rate is in line with the literature. The BOK noted that their estimate of the neutral real interest rate was between zero and one. Staff was not able to assess the authorities' methodology and compare it to the one presented in the SIP. Nevertheless, the BoK staff did not object to the methodology presented in the SIP.

Financial

17. ***Could staff share their views on the potential for additional demand-side and supply-side measures to complement macroprudential measures in addressing housing market issues?***

18. ***Can staff indicate if they discussed with the authorities other measures to slow the growth in lending to households, including on the supply-side?***

- Staff has the view that, to avoid risking a hard landing in real-estate and credit cycles, the authorities should wait and evaluate the effectiveness of recent prudential policies before considering further measures.

- Over the past 2 years the authorities have introduced targeted regional prudential measures (tighter LTV and DTI limits) for properties in those areas experiencing high real estate price inflation. The authorities have also introduced several measures that directly target credit supply, which has affected the housing cycle. First, to reduce leakages the authorities have extended borrower-based macroprudential regulations to cover non-bank lending. Second, the FSC have introduced a stressed DTI, with banks not allowed to grant a new mortgage loan if the stressed-DTI ratio breaches an 80 percent ceiling. Third, banks have been mandated to attach a higher risk-weight for high risk loans (defined as loans with an LTV above 60 percent). Fourth, a household-based counter-cyclical capital buffer will be introduced. Finally, banks must also submit plans to the FSC on the amount of new loans they plan to originate.

- New house price indicators suggest that these tighter prudential policies are having an impact in softening demand for mortgage loans, and reduced housing transactions that slowed house price inflation. Residential investment is also moderating. The authorities should continue to closely monitor the rise in unsecured lending, which in some cases is being used to meet LTV requirements, and growth in non-bank mortgage loans.

19. ***On a related note, we would be grateful if staff could clarify how they define "disorderly market conditions" particularly since staff indicate that the authorities only intervene when markets are disorderly.***

- Staff consider disorderly market conditions as situations in which the exchange rate can stop working as a normal shock absorber and start playing a disruptive shock-amplifying role. In these circumstances, markets stop operating normally, they become one-sided and illiquid, normal market-clearing breaks up and price signals may not be informative, and conditions may be prone to herd-like dynamics.

- Devising quantifiable and objective empirical indicators remains a challenge, notably because policy responses to such episodes may mask their manifestations in exchange rates. Staff hence relies of a suite of indicators, including sudden stops or reversals of capital flows, prices, volatility and illiquidity conditions in debt, equity, and FX markets, and indicators of credit crunch, as well as discussions with market participants and the authorities.

20. ***Does staff believe that the buffers accumulated by Korean financial institutions are ample enough to withstand severe shocks?***

- Banks' capital, liquidity coverage and net stable funding ratios are above minimum Basel requirements. Average LTV ratios for the banking sector are around 60 percent, while the level of NPLs is low. The forthcoming FSAP will undertake stress test scenarios that will examine whether this represents enough buffer and resilience in the financial system to insulate the banking system from severe shocks.

21. Have staff applied the Fund's GDP-at-risk framework in reaching their judgment on the extent of financial vulnerabilities, and therefore the trade-offs faced by the BOK?

- Staff have applied the Fund's GDP-at-risk framework, and undertook conditional forecast simulations of real GDP growth in the event that financial conditions sudden tightening due to the materialization of tail-risk events (see Financial Conditions-at-Risk SIP). Should financial conditions tighten significantly GDP growth is projected to slow, and the BOK should stand ready to ease monetary policy to support growth.

22. ***We look forward to learning more about Korea's experience with non-bank macroprudential policy.***

- During the forthcoming FSAP the authorities have requested a review of their non-bank macroprudential policy to (*i*) identify potential leakages in the prudential framework and (*ii*) suggest policies to close such leakages.

23. ***Can staff comments on the utilization of the expired Policy Bank Recapitalization Fund as well as the market appetite for this fund going forward?***

- The Policy Bank Recapitalization Fund expired in 2017, was not drawn down upon, and has been made redundant. There are no plans to restart the fund.

24. ***We share staff concerns that this trend may reflect a migration of loans from household to firms to circumvent prudential regulation; and that a reversal in real estate demand or adverse price adjustments could spur delinquencies for loans in the sector. Do the authorities share these concerns and is there any initiative envisaged to close loopholes in the prudential regulation? Staff comments are welcome.***

- Borrower based macroprudential regulations (LTV, DSR and DTI) have been extended to cover non-bank household lending. With mortgage loans and real-estate price growth slowing, to avoid risking a hard landing in real-estate and credit cycle, the authorities are expected to wait and evaluate the effectiveness of recent prudential policies before introducing further measures. The authorities have requested a review of their non-bank macroprudential policy framework to (*i*) identify potential leakages and (*ii*) suggest policies to close such leakages during the forthcoming FSAP.

25. ***On the authorities' measures to cap the leverage on foreign exchange derivative positions and to impose a levy on the foreign currency funding, we note that the authorities differ from staff, as they do not see these measures as residence-based or limiting capital flows and thus, insist on their position to have them classified as***

macroprudential measures under the Fund's Institutional View. Staff's comments are welcome.

26. ***We are not sure about the staff's assessment on the leverage cap on banks' foreign exchange derivatives positions and the levy on foreign exchange funding in respect to the Institutional View on capital flows. We would appreciate if staff could elaborate more on this issue.***

27. ***Staff argue that alternative measures should be considered, that directly address the systemic risks but are not designed to limit capital flows. We agree that such alternative measures should be used where available. Are staff able to elaborate further on what measures they consider appropriate?***

28. ***We also call on staff to clearly state when policies in IMF member countries diverge from the IV on CFMs/MPMs. Can staff clarify that they consider the two measures to be CFMs/MPMs and identify possible alternative measures that could replace the derivatives cap and/or FX levy?***

- The leverage cap on banks' foreign exchange derivatives positions and the levy on foreign exchange funding are assessed as capital flow management measures as well as macroprudential measures (CFM/MPMs) according to the IMF's Institutional View on capital flows, because they are designed to limit capital flows and to reduce systemic financial risk stemming from such flows. These measures were introduced after the global financial crisis to prevent excessive build-up of short-term external liabilities and contain banks' currency mismatch risks. Alternative measures that directly address the systemic financial risks but are not designed to limit capital flows will be explored as part of ongoing work in the context of the forthcoming FSAP.

Fiscal

29. ***We note that on the one hand staff notes that aging will require higher revenue mobilization in the future and on the other, that the structural balance should be reduced towards zero in the coming years. Staff comments about how the different variables are expected to behave are welcome.***

- Outlays for pensions and healthcare will increase rapidly especially after 2030, and staff projections indicate that Korea's debt-to-GDP ratio is expected to remain around 40 percent until then, taking into account the increase in pension- and health-related public spending, and assuming no change in the revenue-to-GDP ratio. Hence, Korea has substantial fiscal space in the medium term.

- In staff's view, this fiscal space should be used to foster inclusion and reinvigorate long-term growth, given increasing income polarization and slowing potential growth. Social protection should be strengthened on a sustained basis to address inequality, boost consumption-led growth, and contribute to rebalancing. Fiscal spending should also focus on buttressing female labor force participation and fertility. Fiscal measures can also play an important role in facilitating the implementation of reforms to make the labor and product markets more flexible.

- In the longer term, fiscal challenges from the aging population will necessitate greater revenue mobilization, as discussed in the staff report.

30. ***Could staff comment on what is the rationale for having a progressive corporate income taxation in Korea?***

- Korea has a progressive corporate income taxation, entailing four marginal tax rates (10 percent, 20 percent, 22 percent and 25 percent). Staff's understanding is that low marginal tax rates are in place to support SMEs. The highest tax bracket (25 percent) was created in 2017 (before there existed only three tax brackets, the highest being 22 percent) for very large companies, with a taxable amount of KWR 200 billion. The objective stated by the government was to "pursue fair taxation" and increase tax revenues.

31. ***Should the broader measurement of labor market slack (i.e., plus discouraged workers) be considered, would the staff's advice change in terms of the extent of the needed fiscal stimulus in 2019 and in the medium-term?***

- Staff's advice regarding the needed fiscal stimulus in 2019 takes into account the estimated output gap of -0.4 to -1.1 percent of GDP, which reflects measures of labor market slack (e.g., discouraged workers). Staff advocates a reduction in the structural balance as a share of GDP of at least 1 percent in 2019. The size of the recommended expansion also takes into consideration the efficiency of public expenditure, as a much larger increase in government spending in one year could hinder the efficiency of fiscal spending.

32. ***Could staff elaborate the reasons on revenue outturns since 2016? And how do staff assess the authorities' view on the revenue performance in 2019?***

33. ***We note the authorities' reservations about the likelihood of a recurrent revenue overperformance and thus, would appreciate if staff could elaborate more on the desirability of their recommended fiscal expansion (i.e. 0.6 percent of GDP).***

- From 2016 to 2018 revenues overperformance has averaged 0.7 percent per year. In 2018 the revenue outturn was 0.9 percent of GDP higher than projected in the budget. Recent years revenue overperformance was driven by taxes on property. Last year revenue overperformance was mainly driven by corporate income taxation from stronger-than-expected corporate earnings as well as taxes on property and equity assets.

- Staff's revenue projections for 2019 are based on estimated elasticities. Staff agree with the authorities that revenues overperformance this year will not be a strong as in 2018. Nevertheless, staff expect some revenue overperformance, even assuming a decline in the estimated elasticities.

34. ***In this light, we wonder whether there is enough short-term absorption capacity for an even faster expenditure increase as suggested by staff and whether this could not undermine fiscal efficiency.***

- Staff recommends a reduction in the structural balance of more than 1 percent of GDP in 2019. In staff's view such an expansion could be implemented without hindering the efficiency of fiscal spending. The additional spending should be fiscally efficient and aim at enhancing social safety nets and boosting long-term growth. It should focus on expanding targeted transfers to the most vulnerable, childcare spending to support female participation in the labor market, as well as training and employment services to foster new hiring.

35. ***Could staff elaborate on the gap between the government current fiscal stance and the one that staff would deem appropriate, notably against the background of the latest disappointing economic data?***

- The 2019 budget is projected to lower the structural balance by 0.5 percent of GDP from 2018. In addition, the proposed supplementary budget is expected to lower the structural balance further by 0.4 percentage point (cumulative 0.9 percent of GDP).

- Staff recommend a reduction in the structural balance by more than 1 percent of GDP in 2019, based on the output gap, low inflation, and external imbalances. The latest data also highlighted downside risks and the importance of a strong policy response. Therefore, a supplementary budget of more than 0.5 percent of GDP would be appropriate, with sufficient attention paid to fiscal efficiency. With a debt-to-GDP ratio of around 40 percent of GDP, Korea has substantial fiscal space for such expansion. This will also be consistent with the government's plans to follow a more expansionary fiscal policy in the coming years.

36. ***What are staff's views on the authorities' suggestion to streamline existing tax reductions and exemptions, including the possible yield of such a measure?***

- Staff agree that in the longer term additional revenue mobilization could be achieved by broadening the tax base. Yields on the personal income tax are low in international comparison, due to significant tax deductions. Tax expenditure on industry, including SMEs, which represented about 30 percent of total tax expenditure in 2017, will also need to be reviewed. Addressing distortions in corporate income taxation, including by reducing the number of corporate income tax rates to one, could bring significant efficiency and revenue gains. Depending on the comprehensiveness of these base-broadening measures, it may still be necessary to raise some tax rates, notably the VAT which is relatively low at only 10 percent.

37. ***Staff's comments are welcome on the possibility of using short-term fiscal stimulus over and above the planned level, using substantial fiscal space to boost consumption and growth and reduce precautionary savings.***

- As discussed above, staff advocates a reduction in the structural balance of more than 1 percent of GDP in 2019. The size of the recommended expansion also takes into consideration the efficiency of public expenditure, as a much larger increase in government spending in one year could hinder the efficiency of fiscal spending.

38. ***Still, we would have appreciated more specificity in the Article IV on the sequencing and best practices of implementing Active Labor Market Policies. Drawing on the Special Issues paper on "What Fiscal Policy can do to Increase Employment in Korea," does staff have recommendations?***

- Active Labor Market Policies (ALMPs) should be enhanced and the composition of spending should be reconsidered. Currently, the focus is on creating jobs directly through subsidies, while spending on training and employment services is relatively low. Korea's spending on direct job creation represented more than half of government expenditure on employment support in 2016. About 21 percent of direct job creation spending was targeted at workers above the retirement age of 65 years in 2018. Consideration should be given to supporting income for those aged 65 or above through targeted transfers rather than spending on employment support. Moreover, spending on public employment services that support job-matching and on training should increase.

- In addition, it would be important to periodically review the effectiveness of employment incentives and reassess whether they are properly targeted. Korea devotes a relatively large share of its ALMPs expenditure to employment incentives. The international experience suggests that hiring and wage subsidies can be effective in boosting employment only if appropriately targeted. There are indications that Korea's employment incentives might not be well targeted. For example, there are incentives to support hiring of highly educated workers, even though companies would likely hire competent talent voluntarily even without the subsidy.

Structural

39. ***Do Staff have a view on the employment impact of the 2018 minimum wage increase?***

40. ***Staff finds some evidence that the 16.4 percent increase of the minimum wage in 2018 (with an additional 10.9 percent expected for 2019) may have hurt employment of low-skilled labor, including the effect of the government's Job Stabilization Fund to subsidize SME's jobs. With this evidence, it might be too soon to extract conclusions and, furthermore to have a complete picture it would be desirable to assess the impact of this rise in the minimum wage on indicators of inequality, in-work poverty, etc. Notwithstanding the difficulties of this type of assessment, has staff attempted to estimate any of these effects?***

- Staff agree that it is still too early to conduct a formal analysis of the full impact of the increase in the minimum wage. Nevertheless, studies from similar experiences in other countries suggest that (1) higher minimum wages tend to price low-skilled workers and youth out of the labor market, thereby decreasing employment; and (2) the increase in the minimum wage policy can act to lower wage inequality by increasing wages in the bottom of the distribution for the workers that remain in employment. The available evidence for Korea so far seems consistent with these findings. The available evidence for Korea so far seems consistent with these findings, as employment in low productive sectors has weakened and unemployment among low skilled workers has risen relatively more.

41. ***In this regard, we would be cautious in setting the OECD average minimum to average wage as a benchmark and would have needed more development in the report to better understand how the minimum wage level evolved compared to productivity gains over the recent years – staff comments are welcome.***

- Historically the minimum wage followed the average wage, which broadly tracked productivity growth. However, the cumulative minimum wage increase in 2018-19 of close to 29 percent far exceeded productivity growth in recent past and the expected growth in near future.

42. ***We take note that a bill has been submitted to Parliament aimed at improving the minimum wage setting framework. Could staff provide some details and***

preliminary assessment on the main measures considered? How will the sub-committee of experts set the upper and lower bands of the minimum wage?

- The proposed mechanism is a two-step approach to setting the minimum wage. In the first step, the “range setting committee” sets a range for the minimum wage increase. In the second step, the “decision making committee” makes a final decision within the preset range. Both committees will have representatives from workers, businesses, and the government. To ensure diversity, the new law stipulates inclusion of representatives from the youth, woman, contract workers, SMEs employees, and small business owners. Staff welcome the broader representation of the work force in this framework.

43. ***Could staff provide a brief assessment of the progress made towards achieving the goals set forth in the Paris Agreement?***

44. ***We wonder whether staff has discussed with the authorities Korea’s mitigation strategy to reach the Paris agreement pledges and whether some lessons have been learned from the ETS experience so far?***

- Korea has formulated a goal to reduce emissions by 37 percent from a business as usual baseline by 2030. To this end, Korea in 2015 launched an emission trading scheme covering around 70 percent of total emissions. Until 2017, allowances were cut by 2 percent per year and issued free. Until 2025, 90 percent of the allowances will be issued free, while the annual cuts in allowances are still to be decided. The government also plans to raise the share of renewables from 6 to 20 percent by 2030. Korea’s mitigation efforts were not discussed during this consultation.

45. ***While high educational costs are often pointed out as a background of low fertility rate in Korea, how do staff assess the effectiveness of the authorities’ measures to tackle low fertility rate?***

- The authorities have taken measures to increase fertility, including additional spending on childcare and the introduction of the new law on reducing maximum working hours. There is scope to further increase spending on early childhood care. Additional measures to boost fertility could include promoting shared parental leave and fostering a working culture supportive of flexible-working arrangements. Also, it will be important to monitor implementation of the new law on maximum working hours to ensure an effective and widespread decline in hours worked across sectors.

46. ***Staff’s comments are welcome on the mismatch in the labor market due to the decline in manufacturing amidst growing tech and service economy, combined with an ageing population.***

- Staff agree that reorienting Korean economy towards more balanced and inclusive one would also be helpful in addressing mismatches in the labor markets. Corporate restructuring in some manufacturing sectors (e.g., shipbuilding, shipping) calls for reallocation of workers in these sectors. In addition, the mismatches in labor demand and supply resulting from a rapid population aging and/or automation are another challenges the Korean economy faces. It is important that the authorities' longer-term labor market policies consider the potential impacts of these structural factors—e.g., industrial structure, population aging, and automation—on the labor markets more comprehensively. Furthermore, with the increasing importance of service sector in the Korean economy, productivity improvements in the service sector should be ensured to provide high quality jobs.