State of the World Economy, 2011-2012:

Whither or Wither?

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This volume contains the speeches and papers that were presented that day and subsequently further refined by the authors to reflect discussions during the conference.

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The Ongoing Global Crisis and Long-Run Growth Prospects for South Korea

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South Korea is arguably the premier development success story of the last half century. For forty-five years starting in 1963, the economy averaged over 7% growth annually, and experienced only two years of economic contraction: 1980 after the second oil shock and the assassination of President Park Chung-hee, and 1998 at the nadir of the Asian financial crisis. At the start of that period it had a per capita income lower than that of Mozambique or Bolivia; today it is richer than Portugal, a member of the Organization for Economic Co-operation and Development (OECD), and in November 2010, South Korea will be the first Asian and first non-G-7 country to host a summit of the G-20, the unofficial steering committee of the world economy.

While in comparative terms South Korea largely avoided the worst of the recent global financial crisis, it did not escape unscathed. Experiencing a sudden stop in capital flows following the collapse of Lehman Brothers, between its peak in November 2007 and its trough in March 2009, the South Korean *won* plunged 43% against the U.S. dollar. Although the currency is now appreciating, South Korea has been criticized, most notably by Japanese Finance Minister Yoshihiko Noda, for intervening in the foreign exchange market. Analysis by Cline and Williamson (2010) indicates that the *won* is near its fundamental equilibrium value, however, and that the intervention is justified to prevent overvaluation. In part due to this recent history, South Korea is contemplating the introduction of capital controls and has been pushing the idea of international financial “safety nets” in its chairmanship of the G-20.

Global Context

Subramanian (2010) presents a quantitative analysis of the world economy over the period 2010–30 under three scenarios. In the *baseline* scenario economic growth and international trade are generated from a formal model using experts’ assessments as inputs. In the *convergence* scenario, the world economy recovers robustly from its current travails, and poorer countries converge on the income levels of rich countries. Obviously, the potential for growth acceleration via convergence processes is greater for poor countries such as China or India than for countries such as South Korea that are closer to the technological and per capita income frontier. A final scenario is called the “lost decade.” In this scenario, the rich countries most heavily impacted by the recent financial crisis recover sluggishly, and slow growth in the rich industrial countries acts as a drag on the whole world economy, including South Korea. North Korea remains quiescent in all three scenarios.[1]

1 For the purposes of this paper, contingencies involving North Korea have been set aside to focus on more conventional economic challenges. See Noland (2000) for an analysis of possible scenarios and estimates of the costs and benefits of unification.

At first glance, it appears that South Korea is relatively unaffected by these different assumptions: the growth rate of per capita GDP (measured in purchasing power–adjusted terms ranging from 3.0% in the *lost decade* scenario to 3.5% in the *convergence* scenario). But that difference cumulates to a more than $4,000 difference in per capita income in the terminal year of 2030. Its share of world output remains almost constant at 1.6% in constant dollar terms or 1.1% in purchasing power–adjusted terms across the three scenarios. Perhaps surprisingly, even in the *baseline* scenario, South Korea's trade is projected to rise faster than income, implying an increasing international trade share in GDP, despite its increasing economic maturity.

Korea-Specific Considerations

Given the large role that cross-border exchange plays in the South Korean economy, the general health of the global economy, and specifically the fortunes of China, the United States, Europe, Japan, and India, and other major partners will play an important role in South Korean performance over the medium-run. However, economists normally locate the long-run sources of growth in the availability of the basic inputs to production such as labor and capital, together with productivity growth. In the case of South Korea, during its high growth period it benefited not only from the general openness of the world economy, but also from a rapid expansion of the labor force and a relatively low number of dependents per worker, combined with a significant increase in the educational level of the workforce.[2] Looking forward, however, those favorable demographic factors may go into reverse: South Korea will face a rapidly aging population and a growing legion of nonworking dependents. Under current trends, within the next decade South Korea's dependency ratio will begin rising, and by 2030 population size will begin to decline, falling below its current level by 2040 (Korea National Statistical Office 2006, Japan Center for Economic Research 2007).

Nothing is certain, and changes in underlying behavior could frustrate these projections. Yet if these forecasts prove broadly correct, they imply increases in health and pension burdens that will in turn necessitate adjustments in South Korean policies and practices, such as increasing the retirement age, improving the efficiency of delivery of health care and retirement services, and utilizing female labor, especially educated women, more efficiently. Among the members of the OECD, the club of rich industrial democracies, South Korea has some of the most restrictive immigration policies and may have to reconsider those as well, in response to changing demographics. South Korea's demographic bonus could turn into a demographic onus.[3]

These considerations point to the need to reform the tax system more generally. In the context of likely sluggish growth in some of South Korea's major export markets over the medium-term, the International Monetary Fund in its most recent Article IV consultation recommends removal of tax incentives that favor export-oriented manufacturing over the service sector (International Monetary Fund 2010).[4] The government has begun to address this, albeit by introducing tax incentives for certain specified service industries, rather than moving toward neutrality by removing existing preferences. And looking north, President Lee Myung-bak

2 In an economic, though not political or social, sense the demographic bonus may have been reinforced by wage repression at the point of a gun, which, together with capital channeling, may have boosted investment, at least in traded goods.
3 For more on South Korean demographic issues, see OECD 2008 and Schiff and Syed 2008.
4 See also OECD 2008.

has raised the possibility of a "unification tax" to hedge against the world's largest contingent liability.

South Korean investment has not returned to levels existing prior to the 1997–98 crisis, though in this respect South Korea is not alone: investment in other crisis-affected Asian economies has never fully recovered either. This pattern may reflect over-investment during the 1990s boom, secularly falling profitability as capital is accumulated, and political developments over the past decade. The rise of progressive political forces following the financial crisis, their contentious relationship with the corporate sector, and greater willingness to side with the unions in labor disputes may have contributed to a reduction in business confidence and a consequent attenuation by the business sector to engage in irreversible commitments, which, after all, is what investment represents. Labor market regulations, which make it difficult to fire permanent workers once they are hired, further reinforce caution with respect to expansions of capacity, which may be effectively irreversible in the payroll dimension as well.[5] Direct foreign investment flows into South Korea are relatively sluggish; in a recent UNCTAD survey, South Korea placed 130th out of 141 countries with respect to inward foreign investment performance, and outward investment is rising (UNCTAD 2008). The undeniable impression is that South Korea is losing its luster as a location for production.

Under such circumstances, squeezing the maximum productivity out of labor and capital inputs is essential to maintain growth. South Korea faces important competitive challenges posed by the country's intermediate position between its neighbors, low-wage China and high-technology Japan. Approaching the technological frontier, South Korea faces significant challenges in stimulating productivity growth. It is tempting to think of spurring productivity increases in terms of technological upgrading, and indeed, South Korea's technological progress, particularly in information technology, has been phenomenal. But increasing productivity involves more than just technological change; indeed, technology, narrowly defined, may not even be among the most important drivers. Financial sector reform, for example, could have a considerable impact on the availability of capital to underwrite the commercialization of innovative activity. Changes in labor market regulations could have an equivalent impact with respect to the efficient utilization of labor.

One can conceptualize the process of productivity advance as encouraging innovation in emerging sectors or activities, while at the same time terminating practices that discourage productivity increases in existing activities. Where South Korea falls badly behind is in the heavily regulated service sector, and it is here that the greatest opportunities for productivity increase lie.

In terms of productivity, the South Korean service sector lags the industrial sector, and this divergence is far larger in South Korea than it is in most other OECD countries. In fact, estimates by the IMF and the Hyundai Research Institute indicate that while total factor productivity growth, a concept that measures productivity increase taking the application of both labor and capital into account, has been rising at a rate of 3–4% a year outside the service sector over the last quarter century, productivity in the service sector has actually declined (Schiff 2007, Hyundai Research Institute 2010). According to these calculations, South Koreans are actually getting less output in the service sector, once inputs of labor are taken into account, than they

5 See OECD 2005, 2008 for further details.

were in the 1970s.[6] Whatever the specifics, considerable evidence suggests that South Korea faces a real problem with respect to service sector productivity—and the importance of this problem is growing. China's rise means that manufacturing is likely to play a smaller role in the South Korean economy in the future, a trend that will be reinforced domestically by the growth of South Korea's elderly population, who tend to consume relatively more services than the population as a whole. The service sector could also be a contributor to the balance of payments; it has been estimated that the *Hallyu* phenomenon, the increasing exports of South Korean music, "K-pop," TV programs, films, games, and the like, is contributing $1.5 billion in value-added to the economy and $1 billion in service exports, a figure that could rise dramatically if counterfeiting, especially in China, was eliminated (Choi 2010).

Technological upgrading could increase service sector productivity, but the lack of use of cutting edge technology appears to be less the cause than a symptom of the sector's woes, which are more closely associated with institutional policies and practices that impede competition, particularly by facilitating barriers to entry by new competitors, both foreign and domestic. The time, cost, and number of procedures to create a new firm are above the OECD average. The situation is further complicated by policies that at once impose barriers to entry and then effectively subsidize incumbent SMEs that dominate the service industry (OECD 2008, 2010; IMF 2009). To make matters worse, the stock of foreign inward investment in the service sector is among the lowest observed in industrial countries, as is the share of research and development accounted for by the service sector (OECD 2010). Reforms could include extending deregulatory practices introduced to six Free Economic Zones to the entire country, reforming restructuring practices with regard to failing SMEs, and decriminalizing the personal bankruptcy code to encourage more expeditious restructuring by financially challenged entrepreneurs.

Fortunately, financial sector development could both increase productivity in that important sector and encourage increased aggregate saving and investment, increase the allocative efficiency of investment, improve access to capital to productive SMEs, and, by extension, stimulate the degree of competition in the economy more generally. In the context of the current crisis, the IMF has suggested a number of reforms, including linking support more clearly to restructuring efforts and upgrading bank supervision and regulation (IMF 2009).

What is likely to prove difficult over the longer term is balancing the need to increase the degree of financial integration between South Korean corporations and their foreign counterparts, with the sensitivity of South Korea, located between the large economies of China and Japan, to impede this process to preserve national corporate autonomy. In the future, the development of large sovereign wealth funds is likely to enhance the salience of these concerns, raising the specter of foreign government affiliated entities taking over South Korean firms. South Korea has a history of xenophobia when it comes to foreign investment; one hopes that currently contemplated capital controls undertaken in response to the crisis are not used for, or do not morph into, more general restrictions on foreign investment.

Such developments are particularly unfortunate in the context of the perennial challenges

6 These calculations should be approached with a certain degree of skepticism: the exercise embodies a host of assumptions about the nature of technological change (nicely reviewed in Pack 2001), assumes that factors are paid their marginal products, which is almost surely not the case in South Korea during at least the early part of the sample period, and the econometric literature rejects the constant-returns-to-scale translog production function as an adequate representation of the South Korean economy, or at least its manufacturing sector, over the relevant time period (Kwon 1986, Park and Kwon 1995, Kwack and Lee 2005). The scale of economy specification issue is less of a concern with respect to the service sector, however, and this is where the real problems lie.

posed by South Korea's industrial structure, which is dominated by a small number of large *chaebol*, or family-dominated conglomerates. Foreign corporate competitors and private investors are one potential source of market discipline, which can be imposed on the *chaebol* without resorting to direct regulation, and a potentially positive and constructive force. The foreigners and the emerging good governance movement represented by organizations such as the Center for Good Corporate Governance and the Korea Corporate Governance Fund are natural allies in promoting more fair and transparent practices in the South Korean corporate sector.

Beyond the financial sector, the nature of South Korean labor market regulation has long encouraged segmentation, where there is a small cadre of relatively secure and legally protected employees, who are mainly employed by *chaebol* or public enterprises, and a much larger group of part-timers and workers employed by SMEs, who labor under far less secure conditions. The result is a dualistic system that is rigid in some respects and flexible in others, confers considerable protection to some workers, but few safeguards to others, and encourages confrontational behavior by South Korea's unions. When South Korea was confronted with the specter of mass unemployment during the 1997–98 crisis, it was forced to expand the existing social safety net, yet the provision of social insurance still lags comparators in the OECD. The crisis likewise encouraged reform of some of South Korea's most debilitating labor practices. Looking forward, South Korea could gain from further diminishing the degree of labor market dualism and segmentation, continuing to rein in highly restrictive regulations (with respect to issues such as hiring and firing, for example) that hamper South Korea in international competition, while building legislation protecting the interests of non-regular workers and encouraging the smooth deployment of labor to its most productive uses.[7]

Beyond these generic improvements in the functioning of capital and labor markets, there is scope for more narrow reforms to the innovation system. As South Korea approaches the technological frontier, there are fewer opportunities for imitation and reverse engineering, while at the same time foreign firms are likely to be increasingly reluctant to transfer technology to potential South Korean competitors. The OECD has identified a number of areas of potential improvement (OECD 2005). South Korea's innovative activities are concentrated in a limited number of sectors, and research and development activity in services is low. Considerable scope exists for improving the integration of innovative activities occurring in the universities and other publicsector institutions and the private sector within South Korea, as well as the degree of cross-border integration between researchers in South Korea and those located elsewhere. As in the case of financial and labor market reforms, the government of South Korea is making efforts in this direction, though more remains to be done.

A final challenge confronting South Korea is growing income and wealth inequality. Again, South Korea is not alone in this regard: technological change and globalization have resulted in increased inequality in many countries, and South Korea is far, far from the worst. Yet the rise of inequality has been particularly pronounced in South Korea, and unsurprisingly it is an enormously sensitive issue. As South Korea grapples with inequality going forward, the key issue is to use public policy in a constructive way, by addressing lingering dualism in the labor market, for example. The risk is that inadequate or ineffective public policies in the face of the widening gap could provoke a political reaction that could damage the fundamental drivers of South

7 See OECD 2005, 2008, and Kim 2007 for more detailed discussions of labor market issues.

Korean success. This concern is made more acute by the imperative to maximize productivity growth created by the ongoing medium-term challenges posed by the global financial crisis, South Korea's looming longer-term demographic challenge, and the predicament created by its economic and geographic placement between Japan and China.

Conclusion

South Korea is an open economy, and there is understandable concern about how external conditions could affect the country's economic performance. However, setting aside possible contingencies involving North Korea, the primary conventional economic challenge facing South Korea is located not so much in its external relations, but rather in a nexus of interrelated problems revolving around the country's demographics, long-term fiscal position, and lagging productivity in the services sector.

These are daunting challenges. Yet two generations ago few would have predicted South Korea's stunning rise. One can only hope that the strengths that the country has exhibited in achieving its extraordinary past accomplishments will be equally evident as it addresses its future challenges.

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